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In The

Supreme Court of the United States

October Term, 1998

SUSAN TAYLOR MARTIN,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Where spouses or former spouses have not partitioned or otherwise divided their community property, and one of them files a chapter 7 bankruptcy case, the non-filing spouse's half ownership in the community property becomes property of the bankruptcy estate by operation of 11 U.S.C. § 541(a)(2). When thereafter, but prior to termination of the bankruptcy estate, the non-filing spouse sells to a third party her community claims to a distribution of her half of the remainder of the bankruptcy estate:

1. Is the claim of the non-filing spouse to a distribution of half of the remainder of the bankruptcy estate property inherently a claim to a distribution which is tax exempt under 26 U.S.C. § 1398(f)?

2. Did the Fifth Circuit err in refusing to apply the "Origin of Claim" doctrine to the proceeds from the sale of such a claim?

PARTIES TO THE PROCEEDINGS

All parties to the proceedings in the United States Court of Appeals for the Fifth Circuit are listed in the caption: petitioner, Susan Taylor Martin, plaintiff-appellant below, and respondent, the United States of America, defendant-appellee below.

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PETITION FOR A WRIT OF CERTIORARI

Susan Taylor Martin petitions for a writ of certiorari to review the judgment of the Court of Appeals for the Fifth Circuit entered in this case on November 12, 1998.

OPINIONS BELOW

The opinion of the Court of Appeals affirming the ruling of the District Court was entered on November 12, 1998, is reported at 159 F.3d 932, and is reprinted in the appendix ("App.") to this petition. App. 1-14.

The order of the Court of Appeals denying rehearing in this case was entered on January 13, 1999 and is reprinted in the appendix to this petition. App. 36.

The decision of the District Court for the Eastern District of Louisiana (McNamara, J.), granting summary judgment in favor of the United States on all remaining issues and which the Court of Appeals affirmed, was entered on August 27, 1997, is reported at 1997 W.L. 537688, and is reprinted in the appendix to this petition. App. 15-33.

An earlier decision of the District Court for the Eastern District of Louisiana (McNamara, J.) granting partial summary judgment in favor of Susan Taylor Martin as to the nature of the bankruptcy claim that she sold, was entered on November 21, 1996, is reported at 1996 W.L. 673958, and is reprinted in the appendix to this petition. App. 34-35.

JURISDICTION

The Court of Appeals entered its judgment on November 12, 1998. The petitioner filed a timely request for rehearing, which was denied on January 13, 1999. This Court has jurisdiction to review the judgment of the Court of Appeals under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

The statutory provisions at issue are all reprinted in the Appendix to this petition: 11 U.S.C. § 541(a)(2) at App. 37, 11 U.S.C. § 726(a)(6) at App. 38, and 26 U.S.C. ("IRC") § 1398(f)(1) and (f)(2) at App. 39.

STATEMENT OF THE CASE

Nature of the Case

This is a taxpayer's action in the United States District Court for a refund of taxes and interest paid to the U.S. Internal Revenue Service ("IRS") after assessment against the taxpayer.

In February, 1991 Kenneth G. Martin ("Ken"), a Louisiana resident, filed a Chapter 7 bankruptcy case in which his estranged wife, Susan Taylor Martin ("Susan") did not join as a petitioner for relief. When the petition was filed Susan and Ken had not partitioned any of their

community property.[1] At the moment of filing, Susan's half of the community property was transferred to Ken's bankruptcy estate by operation of 11 U.S.C. § 541(a)(2). App. 37. Susan received in exchange a "claim in bankruptcy", which entitled her, at such future time as the administration of Ken's bankruptcy case was completed, to one-half of any property or funds derived from the community that remained after the administration of his bankruptcy estate pursuant to 11 U.S.C. § 726.

On July 1, 1993, more than two years after Ken filed his bankruptcy case, Susan assigned and sold her claim against his bankruptcy estate to Tenneco Gas Louisiana, Inc., an indirect subsidiary of Tenneco, Inc. ("Tenneco"). Prior to the bankruptcy filing, Tenneco was the largest obligor to Ken and Susan, and after the filing of the bankruptcy case, the largest obligor to Ken's bankruptcy estate. This was because Tenneco was the indemnitor on a valuable Gas Purchase Contract owned by the Martins which required its indemnitee[2] to purchase large

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[1] Community property systems govern marital property arrangements in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Louisiana's arrangement is typical:

> Each spouse owns a present undivided one-half interest in the community property. Nevertheless, neither the community nor things of the community may be judicially partitioned prior to the termination of the regime.

La. Civil Code Article 2336.

[2] The indeminitee was Louisiana Intrastate Gas Co. ("LIG"), which was a subsidiary of Tenneco when the Gas Purchase Contract was signed.

quantities of gas at a fixed price (which at all times pertinent to this case was quadruple the market price) from Ken and Susan through their community property corporation, Martin Intrastate Gas Co. ("MIG"). Although Ken omitted any mention of the Gas Purchase Contract from his bankruptcy schedules, Susan provided the information and evidence which enabled Ken's trustee to establish that the Gas Purchase Contract was community property and should have been listed by Ken as an asset.[3]

Susan's sale to Tenneco of her claims was for a cash consideration of $5.75 million. Tenneco properly substituted itself as a transferee of the claim under Bankruptcy Rule 3001(e). Tenneco thereby became a creditor of the bankruptcy estate and hence entitled to receive from the estate any distribution of one-half of any surplus or remainder of the Martins' former community property.

Susan timely filed her federal income tax return for calendar year 1993 and attached an IRS Form 8275 in which she reported the $5.75 million she received from Tenneco and disclosed her position that those funds were not taxable. The IRS disagreed and assessed against her a deficiency calculated on the assumption that Susan was not entitled to the non-recognition provisions of 26 U.S.C. § 1398(f), that she had a zero tax basis in the claim, and

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[3] Although the contract was between LIG and MIG, the trustee of Ken's bankruptcy estate prevailed in certain litigation in the Bankruptcy Court which declared MIG and the Gas Purchase Contract to be the community property of Ken and Susan. Decision of Hon. T.M. Brahney, III, dated August 19, 1993 in *Marrero versus Bordelon, et als.*, Adversary 92-1036 (Bankr. E.D. La. 1993).

that therefore in the view of the IRS the entire $5.75 million was taxable income.

Procedural History

In February, 1996, Susan paid the assessed taxes and interest, then filed an administrative claim for refund. The IRS disallowed her refund claim and she immediately filed the instant proceeding in federal district court as a suit to recover, as a refund, the taxes and interest she had previously paid. After the government answered and issue was joined, she filed a Motion for Partial Summary Judgment to answer the threshold question as to "what" she sold to Tenneco in 1993. Susan's argument was, and remains, that she disposed of only her claims against her ex-husband's bankruptcy estate to an eventual distribution, and did not sell or transfer any assets of the estate itself. The district court agreed and granted her motion. App. 34. The government did not appeal.

Having thus narrowed the issues to be decided, Susan then filed another motion for summary judgment asserting several reasons why the payment from Tenneco should not be treated as taxable income. *Inter alia*, she argued that because transfers from bankruptcy debtors to their estates and final distributions from those estates back to such debtors are tax exempt under IRC § 1398(f) (App. 39), then equal protection of the law requires that debtors and their non-filing spouses be treated similarly with respect to the taxation of those distributions. Susan argued that the "Origin of Claim" doctrine required the

application of the tax exclusion to sale proceeds she received from Tenneco.

The government opposed Susan's motion and filed a cross-motion for summary judgment which the district court granted. App 15. The district court found that Susan's sale proceeds were not exempt from taxation under IRC § 1398(f) and further that Susan had not established a tax basis in the claims she sold, thereby concluding that the entire $5.75 million was taxable.

REASONS FOR GRANTING THE WRIT

I. IF NOT REVERSED BY THIS HONORABLE COURT, THE FIFTH CIRCUIT'S DECISION WILL BECOME CASE LAW PRECEDENT FOR THE LEVY OF TAXES UPON WHAT IS IN ESSENCE A RETURN TO THE NON-FILING SPOUSE OF HIS OR HER OWN PROPERTY, WHILE EXEMPTING FROM TAX THE RETURN OF THE IDENTICAL PROPERTY TO THE FILING SPOUSE.

The Fifth Circuit, as well as the District Court, held that the non-recognition provisions of IRC § 1398(f) do not apply for three reasons. The *first reason* is because a non-filing spouse, such as Susan, is not a "debtor". This first reason applies to all non-filing spouses in community without regard to whether the spouse sells his or her claim or retains his or her claim and waits for a distribution from the bankruptcy estate. The second and third reasons given in the opinion apply only to the situation where the non-filing spouse sold his or her claim to a

third party. These reasons are discussed in Section II below.

A. Susan Martin should be treated "as a debtor" under IRC § 1398(f).

Congress enacted IRC § 1398 in 1980 to remove " . . . the uncertainty and litigation concerning the Federal income tax liability of the debtor." S.Rep. No. 1035, 96th Cong., 2d Sess. 25 (1980). IRC § 1398 applies to individuals who file for Chapter 7 relief.[4]

The purpose of IRC § 1398 is to "provide for a debtor's ability to begin his or her economic life anew . . . Moreover, any (bankruptcy) estate tax liability is generally confined to the estate and its assets . . . All of this helps further the fresh start policy in individual debtor bankruptcies." C. Richard McQueen & Jack F. Williams, TAX ASPECTS OF BANKRUPTCY LAW AND PRACTICE, Section 20.5 at 20-3 – 20-4 (3d Ed. 1997)

IRC § 1398(f)(1) states that "a transfer (other than by sale or exchange) of an asset from the debtor to the estate shall not be treated as a disposition for the purposes of any provision of this title assigning tax consequences to a disposition". App. 39. Paragraph (f)(2) parallels (f)(1) and provides that transfers *from the estate to the debtor,* except

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[4] IRC § 1398 reads in part as follows:

(a) "Except as provided in sub-section (b), this section shall apply to any case under chapter 7 (relating to liquidation) or chapter 11 (relating to reorganizations) of title 11 of the United States Code *in which the debtor is an individual" (emphasis supplied).*

transfers by sale or exchange, are not taxable dispositions. App. 39, *emphasis supplied.*

Upon her ex-husband's filing Chapter 7 bankruptcy in 1991, a transfer occurred, involuntarily and by operation of law, of all Susan's ownership interest in property of the unpartitioned community. *In re Hendrick,* 45 B.R. 976 (Bankr. M.D.La. 1985). Two bankruptcy cases arising in Louisiana are the seminal cases for application of 11 U.S.C. § 541 to an unpartitioned community when only one spouse files for bankruptcy: *In re Hendrick,* 45 B.R. 965 and 45 B.R. 976 (Bankr. M.D. La. 1985). The Bankruptcy Court for the Middle District of Louisiana in the first *Hendrick* case had to determine whether, when only the ex-husband filed a petition in bankruptcy, the court should allow only one set of exempt property under La. R.S. 13:3881.[5] Although the trustee argued that only one set of exempt property should be allowed, the court recognized that the non-filing ex-wife should be treated equally and allowed two sets of exempt property, holding that if only one exemption were awarded, the non-filing spouse "would be deprived of assets that R.S. 13:3881 clearly intended for his or her benefit." *Hendrick,* 45 B.R. at 972. The second *Hendrick* case held that under 11 U.S.C. § 541(a)(2), property of the bankruptcy estate includes the entire unpartitioned community, regardless of whether the parties were married, separated, or divorced. *Hendrick,* 45 B.R. at 983.

In the case of Susan and Ken, 11 U.S.C. § 541(a)(2) operates upon their community property interests in

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[5] R.S. 13:3881 is the primary Louisiana Exemption Statute.

exactly the same manner. It takes those interests away from them and makes those interests property of the bankruptcy estate. *Certainly both are similarly situated with respect to the loss of their half interests in their community property at the moment of filing.* Susan has always maintained that the language of 11 U.S.C. § 101(13), as changed by the 1978 Bankruptcy Act to replace the term "bankrupt" in favor of the broadened definition of "debtor", includes a non-filing spouse in community, or at least justifies under the equal protection of the law doctrine the extension of the non-recognition provisions of IRC § 1398(f) to the non-filing spouse in community.[6] That is, she is entitled to be treated "as a debtor" for purposes of applying IRC § 1398(f).

Susan loses her property in exactly the same manner as Ken does. The government argued that she is not similarly situated because the non-filing spouse is given a

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[6] Under the repealed bankruptcy act Section 1(4) [previously codified as 11 U.S.C. § 1(4)], a "bankrupt" was defined as:

> "A person against whom an involuntary petition or an application to revoke a discharge has been filed, or who filed a voluntary petition, or who has been adjudged a bankrupt."

Under the 1978 Bankruptcy Act, Congress drafted an entirely new definition which is incorporated in Section 101(13) of the bankruptcy code which defines "debtor" as:

> "Debtor means person or municipality concerning which a case under this title has been commenced."

Susan maintains her position that the new definition is broader than the previous definition which was simply limited to persons who filed a petition, who had a petition filed against them, or who had been adjudged a bankrupt.

preferential right to purchase the former community property with new money from the bankruptcy estate.[7] The argument seems to be that somehow this "right" rises to the level of a retained ownership interest in the property itself. The District Court held, and the government did not appeal, that Susan did not sell any of the property of the bankruptcy estate. The preferential purchase right granted to the non-filing spouse is not a relevant distinction between Ken and Susan because it has nothing to do with how both lose their property interests to the estate under 11 U.S.C. § 541(a)(2), nor as to how estate assets are returned to them under 11 U.S.C. § 726.

B. There are many other non-filing spouses who may face an unjust tax burden because of the Fifth Circuit's decision.

The Fifth Circuit's holding that the non-filing spouse is not a "debtor" under IRC § 1398(f) potentially affects far more individuals than Susan. *It is the first reported case to hold that the non-recognition provisions of IRC § 1398(f)(1) and (f)(2) do not apply to transfers of the community property interests of the non-filing spouse to and from the filing spouse's bankruptcy estate.* According to the 1990 Census, the total population of the nine community property states[8] was 68,113,844 and of that number, 34,699,867

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[7] 11 U.S.C. § 363(i) grants to the debtor's spouse or any co-owner of property of the estate a preferential right to purchase from the estate such property at the price at which any contemplated sale is to be consummated.

[8] See Footnote 1, infra

were either married, separated or divorced.[9] Statistics compiled by the Administrative Office of the United States Courts *for the twelve month period ending September 30, 1998* reveal that there were *397,978* non-business bankruptcy filings in the nine community property states of which *298,824* were chapter 7 petitions.[10]

There are no statistics available as to how many non-filing spouses lost his or her half of the community property by operation of 11 U.S.C. § 541(a)(2), however their number is probably substantial, perhaps in the thousands, given that there were 298,824 Chapter 7 non-business filings in the nine community property states for the twelve month period in 1997-1998.

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[9] United States Department of Commerce, Bureau of the Census, Washington D.C., 20233-0001, 1990 Census of Population, General Population Characteristics, *Table 263.*

[10] Administrative Office of the United States Courts, Bankruptcy Courts, Non-business bankruptcy cases commencing by chapter during the twelve month period ending September 30, 1998, *Table F-2,* Administrative Office of the United States Courts, Washington, D.C. 20544.

Of the three states comprising the Fifth Circuit, Mississippi, Louisiana and Texas, *two* are community property states. The total population of these two states was 21,206,483 and of that number, 10,876,382 were either married, separated or divorced. There were 91,518 non-business bankruptcy filings in the two community property states, of which 50,199 were chapter 7 petitions.

II. THE DECISION BELOW, WHICH REFUSES TO APPLY THE "ORIGIN OF CLAIM DOCTRINE" TO THE SALE PROCEEDS, CONFLICTS WITH PREVIOUS DECISIONS OF THIS HONORABLE COURT IN *LYETH v. HOEY*, 305 U.S. 188, 59 S. Ct. 155 (1938), *UNITED STATES v GILMORE*, 372 U.S. 30, 83 S. Ct. 623 (1963), *WOODWARD v. C.I.R.*, 397 U.S. 659, 90 S. Ct. 1302 (1970) and *UNITED STATES v. HILTON HOTELS CORPORATION*, 397 U.S. 580, 90 S. Ct. 1307 (1970) AND NUMEROUS APPELLATE, DISTRICT, AND TAX COURT CASES WHICH MANDATE THAT THE ORIGIN AND NATURE OF, AND THE ESSENTIAL REALITY OF, ANY TRANSACTION, DETERMINE ITS TAX CHARACTERIZATION.

A. The objectionably narrow reasons given by the Fifth Circuit for not applying the "Origin of Claim" doctrine constitute a rejection of this Honorable Court's *general approach* mandated by *Lyeth v. Hoey, supra*, and later decisions of this Honorable Court, as consistently followed by all Federal Courts.

The second and third reasons given by the Fifth Circuit to justify its refusal to apply the "Origin of Claim" doctrine are: (2) "there was no transfer from the estate" and (3) "Susan did not receive any assets of the estate." App. 7. Some additional reasons given in the opinion are that (a) Tenneco was not adverse to Susan, (b) Susan received the sale proceeds a year prior to any distributions being made from the estate to other creditors/distributees and (c) the sale proceeds did not "extinguish" the claim, i.e., the proceeds were a consideration for a sale and that the claim remained alive in the hands of Tenneco.

Each and every of the foregoing reasons *objectionably narrows* the "Origin of Claim" doctrine to the point of negating it completely. All given reasons focus entirely on the intermediate transaction whereby Susan sold her claim and ignore the origin and nature of the claim itself. Most, if not all, of these reasons have been specifically rejected in decisions of this Honorable Court, other appellate and district courts, and the tax court. All of the reasons are merely *formalistic distinctions*, i.e., distinctions without a difference, and additionally (with reference to the adversity reason) based on obvious error.[11]

The correct tax characterization of property received, or expense/deduction taken, requires that the essential and basic reality be *first* ascertained, *then* the tax characterization identified. It is substance not form that controls. *Gregory v. Helvering*, 293 U.S. 465 (1935). *Lyeth v. Hoey, supra*, involved monies received by a taxpayer in exchange for claims against an estate. For purposes of tax characterization, this Court held that the nature and the

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[11] Susan's financial interests were just as adverse to Tenneco before the filing of the bankruptcy as they were after the filing. It should be remembered that the Trustee is the fiduciary for the debtor as well as the creditors. *Matter of Combined Metals Reduction Co.*, 557 F.2d 179, 196 (9th Cir. 1977), *Matter of Shen*, 7 B.R. 942, 947 (S.D. Cal. 1980), *In re Grodel Manufacturing, Inc.*, 33 B.R. 693, 694, (Bankr. Conn. 1983). Simply because Susan's financial interests in the Gas Purchase Contract were now being asserted against Tenneco by her trustee, it did not take away the basic financial adversity between Susan and Tenneco. The purpose of the bankruptcy system is to make the bankrupt's property available to his creditors and to give any surplus back to him. *In re The Georgian Villa, Inc.*, 55 F.2d 1561, 1562 (11th Cir. 1995).

quality of the claim compromised determines its characterization for tax purposes. This Court rejected a formalistic distinction and mandated an inquiry as to the quality and nature of the claim for which the monies were received. *Lyeth*, at 196. The essential reality is ascertained, then the tax characterization determined.

In *U.S. v. Gilmore, supra*, this Court again reaffirmed the Origin of the Claim theory with respect to the deduction of business expenses. The question there before this Court was whether legal fees incurred by a husband in marital litigation were business expenses or personal expenses. This Court correctly concluded that an examination of the origin and nature of the claimed expenses revealed that they were incurred with the purpose of protecting the husband's personal ownership interest in community property and therefore were personal expenses and not business expenses, thereby rejecting an analysis based upon economic consequences or other formalistic distinctions. *Gilmore*, at 49.

Woodward v. C.I.R., supra, and *United States v. Hilton Hotels Corporation, supra*, were companion cases and both reaffirmed the mandate of this Court that origin and nature of the claims be first ascertained. Once again, "formalisms", "artificial distinctions", "distinctions without differences", and the sequence of intermediate transactions were disregarded as irrelevant to the characterization for tax purposes of property received or expenses/deductions taken. *Woodward*, at 577, 578 citing *Gilmore*; *Hilton Hotels*, at 583.

Other courts have consistently, and without exception, applied the origin of claim theory. In *Turzillo v.*

C.I.R., 346 F.2d 884, at 889 and 890 (6th Cir. 1965), the Sixth Circuit stated that "we still must look for what was the money paid", and further held that *a claimed distinction between a transaction which keeps the property right of the claim alive, and a release that results in the extinguishment of the claim, is nothing more than a "formalistic" distinction and that it has little, if any, merit in determining the tax consequences.*

The 1995 First Circuit case of *Alexander v. Internal Revenue Service*, 72 F.3d 938, 942 (1st Cir. 1995) dealt with a question as to the proper classification of amounts received in settlement of litigation; the Court applied "[t]he well settled rule that the classification of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled, and the amounts received in compromise of a claim must be considered as having the same nature as the right compromised". In *Parker v. United States*, 573 F.2d 42, 44 (Ct. Claims 1978), litigation settlement proceeds were characterized by the origin and nature of the claims which were settled. Referring to *Lyeth v. Hoey*, the *Parker* opinion criticized the government for "glossing over" the Supreme Court's *general* approach in *Lyeth v. Hoey*.

Another case, *Commissioner of Internal Revenue v. Murdoch*, 318 F.2d 414, 416 (3rd Cir. 1963), correctly applied the "Origin of Claim" doctrine to litigation settlement proceeds, holding that the tax characterization of the proceeds is determined by the "nature and basis" of the action settled. In *Victor E. Gidwitz Family Trust*, 61 T.C. 664, 673 (T.C. 1974) the court unraveled and then disregarded numerous intermediate and superficial transactions to identify the origin, nature and character of claims

in litigation (here failure to deliver certain options to purchase real estate), thereby determining that the cash settlement proceeds were capital assets, and hence the receipt of the cash settlement proceeds was entitled to capital gains tax treatment.

Susan submits that the Fifth Circuit's decision in her case directly contradicts its earlier opinion in *Early v. Commissioner of Internal Revenue*, 445 F.2d 166 (5th Cir. 1971). That case involved settlement proceeds of claims against an estate. Citing *Lyeth v. Hoey*, the Fifth Circuit emphasized that "what is received in settlement must be characterized for tax purposes, by the nature of the underlying and disputed claim resolved".

Because the "Origin of Claim" doctrine is a basic principle of tax law, it cannot be qualified or restricted. Any qualifications or restrictions are equivalent to saying that in certain instances the underlying reality, nature and origin of the claim, or transaction in dispute will be ignored and that intermediate transactions, formalistic distinctions, and distinctions without differences will govern the tax characterization.

B. If lower courts can selectively ignore the "Origin of Claim" doctrine, a great uncertainty is imposed upon the buyers and sellers of claims against bankruptcy estates because the tax consequences become unpredictable.

The Fifth Circuit's decision could potentially cause tax problems to any purchasers and sellers of claims

against bankruptcy estates.[12] There is a widespread and economically significant market in the trading of bankruptcy claims. *In re Ionosphere Clubs, Inc. and Eastern Airlines,* 119 B.R. 440, 441 (Bankr. S.D.N.Y. 1990), *In re Olson,* 191 B.R. 991, 992 (Bankr. Minn. 1996), *Collier on Bankruptcy,* Volume 9, ¶3001.08 (1998), C. Fortgang and T. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11,* New York University 14th Annual Workshop on Bankruptcy and Business Reorganizations, P. 121, August 29, 1988. The sale and transfer of claims is a beneficial commercial activity. In business bankruptcies, the sale of claims by creditors provides immediate funds to often cash-starved suppliers who lack the liquidity to wait for confirmation of any plan of reorganization in a chapter 11 case or for any distribution/dividend from the bankruptcy estate in a chapter 7 case.

Although Susan's claim was not that of a commercial creditor, she was a cash-starved non-filing spouse who lost all of her interest in the former community. Susan should not be required to suffer a tax penalty because she decided to sell her claim rather than wait years for the remainder of her community to be returned to her by the trustee in the form of a dividend or distribution in accordance with 11 U.S.C. § 726.

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[12] The transfer of claims is permitted under Bankruptcy Rule 3001(e).

III. THE FIFTH CIRCUIT'S REFUSAL TO APPLY THE ORIGIN OF CLAIM DOCTRINE TO THE SALE PROCEEDS AND ITS REFUSAL TO TREAT THE NON-FILING SPOUSE AS A "DEBTOR" FOR PURPOSES OF IRC § 1398(f) VIOLATES THE RIGHTS OF THE NON-FILING SPOUSE TO EQUAL PROTECTION OF THE LAW UNDER THE FOURTEENTH AMENDMENT OF THE UNITED STATES CONSTITUTION.

An application of IRC § 1398 that results in the differential treatment of filing and non-filing spouses in community raises equal protection concerns. Courts should be and are slow to apply an interpretation of law resulting in a discriminatory application of the government's tax laws. The equal protection requirements found in Section 1 of the Fourteenth Amendment apply to the federal government through the Due Process Clause of the Fifth Amendment. *Bolling v. Sharpe*, 347 U.S. 497 (1954). Decisions to treat two classes of persons differently must be justified by a relevant difference between the two classes.

Under the basic equal protection standard, "classifications are valid unless they bear no rational relationship to the state's objective". *New York City Transit Authority v. Beazer*, 440 U.S. 568 (1979). Stated differently, the government's means must be reasonably related to its ends. As this Honorable Court stated in *U.S. v. Gilmore*, *supra* at 48, "[w]e should be slow to attribute to Congress a purpose producing such unequal treatment among taxpayers resting on no rational foundation." Where one interpretation of a statute leads to an obvious injustice or an absurd consequence, and an alternative construction

that is consistent with justice and the legislative purpose is also available, that alternative interpretation must be adopted by the Court. *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 575, 102 S. Ct. 3245, 3252 (1982).

The only constitutionally *reconcilable* application of IRC § 1398(f) with 11 U.S.C. §§ 541(a)(2) and 726 requires that the non-filing spouse be treated as a debtor for federal income tax purposes with respect to a distribution in satisfaction of her community claim. The Equal Protection clause of the Fourteenth Amendment requires that both Ken and Susan be accorded the same exclusion from taxation on their distributions.

Susan satisfies all elements of standing. First, she was personally deprived of an equal and even-handed application of IRC § 1398(f). She asserts her own constitutional rights based on specific injury. Second, it is indisputable that the challenged governmental conduct caused her injury – the United States' unequal application of IRC § 1398(f) resulted in a denial of her refund claim. Finally, her injury would be personally redressed by an equitable application of IRC § 1398(f), to-wit: a recognition that her claims were for an *after-tax distribution* of half of the remainder of the bankruptcy estate.

Neither do the prudential concerns favoring judicial self-restraint counsel against deciding this constitutional question. Susan here litigates her individual tax liability. She was personally denied the tax treatment that her husband received, a specific complaint, more than a generalized grievance. *Heckler v Matthews*, 465 U.S. 728, at 741 n. 9 (1984). Furthermore, if Susan's right to a tax-free distribution under IRC § 1398 goes unrecognized, then

non-parties will be affected directly. Wright, Miller & Cooper, *Federal Practice and Procedure: Jurisdiction 2d*, § 3531.9.

The Fifth Circuit erroneously concluded that Susan and Ken are not similarly situated. The distinctions raised by the Fifth Circuit either are non-existent or without relevance. First, the ability of a non-filing spouse to file a proof of claim to protect his or her rights to any distribution from the bankruptcy estate does not constitute a valid distinction. Nothing under the Bankruptcy Code precludes a debtor from filing a proof of claim which recognizes his or her right to a distribution of bankruptcy estate property. Indeed a protective filing is often recommended where a debtor believes there will be assets remaining after all creditors are paid. A debtor has the ability to file a proof of claim as a creditor of his own estate under Bankruptcy Rules 3001, et seq., 11 U.S.C. § 501, and 11 U.S.C. § 726(a)(6). App. 38.

Second, the preferential purchase right given to a non-filing spouse under 11 U.S.C. § 363(i) is not a relevant or material distinction between Ken and Susan, and does not justify the government's denial to Susan of the IRC § 1398(f) tax exclusion. Initially, it should be noted that all property acquired by Ken and Susan while married was community property, all of which became property of the bankruptcy estate. *It is an uncontested material fact of this case that all property owned by Ken and Susan at any time material to this case was community*

property.[13] App. 15, 16. Accordingly, because Susan had no assets, she had no ability to exercise the preferential purchase right. Furthermore, this right does not rise to the level of a retained ownership interest in what became property of the estate. The decision of the trial judge on Susan's Motion for Partial Summary Judgment correctly held that Susan did not sell to Tenneco anything other than her own interest as a creditor or claimant for her former half interest of the community property "which had become property of the estate under 11 U.S.C. § 541(a)(2)". App. 34, 35.

A non-filing spouse's right to a distribution of bankruptcy estate property is identical to the debtor's right of distribution. The Fifth Circuit's finding that the parties are not similarly situated is wrong. Indeed for all purposes relevant herein they are *identically situated.* The equitable requirements inherent in the Louisiana Community Property Regime and the Bankruptcy Code require equal treatment under the Internal Revenue Code. In summary, the Fifth Circuit found neither a relevant distinction between the tax treatment of a debtor and a non-filing spouse under IRC § 1398(f) nor a rational basis for treating such identically situated taxpayers differently.

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[13] This means that Susan had no separate property – she lost everything at the moment of filing.

CONCLUSION

The non-filing spouse in community is identically situated with the filing spouse with respect to the loss of his or her respective half of the community property to the bankruptcy estate by operation of 11 U.S.C. § 541(a)(2) and is identically situated with respect to the distribution of their respective halves of the remainder of the community property under 11 U.S.C. § 726. The Fifth Circuit, as well as any other Court, cannot refuse to apply the "Origin of Claim" doctrine for tax characterization purposes. Such a refusal is tantamount to declaring that past decisions of This Honorable Court which mandate the application of the doctrine will be ignored. The exclusion from tax granted to the filing spouse by IRC § 1398(f) must also be granted to the non-filing spouse to avoid a violation of the non-filing spouse's right to equal protection of the law as guaranteed by the Fourteenth Amendment of the United States Constitution. This Petition for Certiorari should be granted.

Respectfully submitted,

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April 9, 1999

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 97-31277
(Summary Calendar)

SUSAN TAYLOR MARTIN,

Plaintiff-Appellant,

versus

UNITED STATES OF AMERICA,

Defendant-Appellee.

Appeal from the United States District Court
for the Eastern District of Louisiana.

(Filed Nov. 12, 1998)

Before WIENER, BARKSDALE and EMILIO M. GARZA, Circuit Judges.

WIENER, Circuit Judge:

In this tax refund suit, Plaintiff-Appellant Susan Taylor Martin ("Susan") appeals the district court's order denying her motion for summary judgment and granting the cross-motion for summary judgment of Defendant-Appellee United States of America (the "government"). Concluding that the district court did not err in holding that Susan must recognize gain on the $5.75 million payment she received from Tenneco Gas Louisiana, Inc.

("Tenneco")[1] for the sale of her claims against her former husband's bankruptcy estate (the "Estate"), we affirm.

I

FACTS AND PROCEEDINGS

Ken Martin ("Ken") and Susan were married in 1958. At all relevant times they lived in Louisiana, and all property that they acquired while married was community property. In July, 1990, Susan and Ken separated; they obtained a legal separation in March, 1991,[2] and a divorce in September of that year.

In February, 1991, before Susan and Ken were legally separated and before they partitioned their community property, Ken filed for protection under Chapter 7 of the United States Bankruptcy Code. As a result, all community property became part of the Estate. Susan did not join in the bankruptcy petition, but filed two proofs of claim to protect her interests in the Estate.[3] Although Ken

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[1] Tenneco Gas Louisiana, Inc. is a subsidiary of Tenneco, Inc.

[2] Susan filed a petition for legal separation in August, 1990. Separation from bed and board was abolished by 1990 La. Acts, No. 1009, § 1 (eff. Jan. 1, 1991). *See* comment (c) to La. Civ. Code art. 101; La. R.S. 9:381-84. For cases arising prior to January, 1991, however, a judgment of separation terminates the community of acquets and gains existing between spouses under the community property regime. Termination is retroactive to the date of filing of the petition for separation. La. Civ. Code art. 2356 (amended 1990).

[3] Originally, Susan indicated that the premise of her claim was an "undivided 1/2 interest in debtor's community." On her

listed no assets in his bankruptcy petition, Susan asserted that the community owned valuable rights under a gas purchase contract.[4]

On July 1, 1993, Tenneco paid Susan $5.75 million for her claims against the Estate.[5] The following day, Tenneco and the bankruptcy trustee executed a settlement agreement pursuant to which Tenneco paid $7 million for an option to buy the Estate's rights and interests in the gas purchase contract.[6] The trustee reported this $7 million payment on the Estate's 1992 federal income tax return.

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amended proof, however, she also asserted "claims for fraud, bad faith management of the community, breach of debtor's fiduciary duty, and any and all other delictual, contractual and quasi-contractual claims."

[4] This contract existed between Martin Intrastate Gas Co. (MIG) – a corporation formed by Ken – and Louisiana Intrastate Gas Co. (LIG) – another subsidiary of Tenneco, Inc. Tenneco entered into all of the agreements relevant to this matter. According to Plaintiff's Statement of Uncontested Material Facts, the contract required LIG to purchase from MIG large quantities of gas at a fixed price, which was (at all times pertinent to this case) quadruple the market price. Although Tenneco, Inc. later sold all of its interest in LIG, it became the indemnitor to and for LIG for all liability and performance under the contract.

[5] On July 9, 1993, the bankruptcy trustee filed a complaint asserting that the $5.75 million received by Susan from Tenneco was the property of the Estate. The bankruptcy court ruled against the Trustee, finding that Susan had sold only her interests as a claimant and not the actual "assets" of the Estate.

[6] The Estate thereby became solvent. On March 3, 1994, Tenneco and the bankruptcy trustee executed an amendment to the 1993 settlement agreement. This amendment – approved by the bankruptcy court – and the various releases executed pursuant to it (a) settled all outstanding claims each party had

Susan timely filed her federal income tax return for calendar year 1993, and attached a Form 8275 in which she set forth her reasons why the $5.75 million she had received from Tenneco was not taxable. The government disagreed with Susan's analysis, and assessed a deficiency calculated by treating the entire payment as taxable income. In February, 1996, Susan paid the assessed taxes and interest, then filed an administrative claim for a refund. The following month, the government disallowed her refund claim.

Immediately following this disallowance, Susan filed suit in federal district court to recover the claimed refund. She then filed a Motion for Partial Summary Judgment on the issue of "what" she had sold to Tenneco in 1993. Susan asserted that she had sold only her claims against the Estate, not any assets of the Estate itself. The court agreed and granted her motion, and the government did not appeal.

Susan subsequently filed another motion for summary judgment in which she asserted that the payment from Tenneco should not be treated as taxable income. The government opposed Susan's motion, and filed a cross-motion for summary judgment which the district court granted. The court found that she had no basis in her claims against the Estate that she had sold to Tenneco

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against all other parties in the various law suits over the gas purchase contract, and (b) effected a distribution of all the assets in the Estate. Pursuant to the amendment, Tenneco agreed to distributions by the trustee of all the property in the Estate – including distributions to Ken – without any distribution to itself in satisfaction of the claims it had acquired from Susan.

and held that the entire $5.75 million she received as proceeds of that sale was taxable. Susan timely filed a notice of appeal.

II

ANALYSIS

A. Standard of Review

We review a grant of summary judgment *de novo*, applying the same standard as the District Court.[7]

B. Applicable Law

Section 61(a) of the Internal Revenue Code ("IRC") provides that individuals shall be taxed on "all income from whatever source derived."[8] "Accessions to wealth are generally presumed to be gross income unless the taxpayer can show that the accession falls within a specific exclusion. Exclusions from income are to be construed narrowly."[9]

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[7] *Firesheets v. A.G. Bldg. Specialists, Inc.*, 134 F.3d 729, 730 (5th Cir. 1998).

[8] 26 U.S.C. § 61(a).

[9] *Wesson v. United States*, 48 F.3d 894, 898 (5th Cir. 1995). For federal income tax purposes, the amount of gain from a sale or other disposition of property is determined by subtracting the basis of the property (generally its cost, see 26 U.S.C. § 1012) from the amount realized on the sale (generally the selling price, see 26 U.S.C. § 1001(a) and (b)). *See Byram v. Commissioner*, 555 F.2d 1234, 1236 (5th Cir. 1977). The entire amount of gain from the sale of property must be recognized by the taxpayer, unless the gain falls within a specific exclusion under the Internal

Susan contends that the payment from Tenneco should not be included in her gross income because it is either (1) an excludable distribution from the Estate pursuant to IRC § 1398(f)(2); or (2) an excludable payment in satisfaction of her inchoate marital rights pursuant to the rule of *United States v. Davis*.[10]

1. IRC § 1398

Under the Bankruptcy Code, the commencement of either a liquidation (Chapter 7) or a reorganization (Chapter 11) proceeding creates a bankruptcy estate comprising all property formerly belonging to the debtor. Property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case,"[11] as well as "[p]roceeds . . . or profits of or from property of the estate. . . . "[12] IRC § 1398[13] treats the bankruptcy estate as a separate entity for tax purposes; the estate is taxed as if it were the debtor with respect to items of income to which the estate is entitled.[14] Section 1398(f) provides that a "transfer (other than by sale or exchange) of an asset *from the debtor* to

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Revenue Code. *See Wesson*, 48 F.3d at 898. Susan does not dispute the *amount* of gain on which she owes taxes, but rather whether she must recognize any gain at all.

[10] 370 U.S. 65 (1962).

[11] 11 U.S.C. § 541(a)(1). It is pursuant to this provision that title to the Martin's unpartitioned community property vested in the bankruptcy trustee.

[12] 11 U.S.C. § 541(a)(6).

[13] 26 U.S.C. § 1398.

[14] *In re Kochell*, 804 F.2d 84, 87 (7th Cir. 1986).

the [bankruptcy] estate"[15] – or *"from the estate* to the *debtor"* on termination of the estate[16] – "shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition. . . . "[17]

The district court held that § 1398(f)(2) was inapplicable to the facts of this case because (1) Susan was a nonfiling spouse rather than a "debtor"[18]; (2) there was no "transfer from the estate"; and (3) Susan did not receive any "asset" of the estate. We agree.

Susan contends, however, that, when all of her and Ken's unpartitioned community property was transferred to the bankruptcy estate, her ownership interest in that property was replaced – by operation of law – with a "claim," specifically, the right to receive a distribution from the sale of the Estate's assets.[19] As she was not required to recognize any gain on this initial transfer, Susan reasons, the government must have been treating her as a debtor for purposes of § 1398(f)(1). Consequently, Susan concludes, she should also be treated as a debtor for purposes of § 1398(f)(2), pertaining to transfers to a debtor from the bankruptcy estate. As a classic flawed syllogism, this argument fails.

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[15] 26 U.S.C. § 1398(f)(1) (emphasis added).

[16] 26 U.S.C. § 1398(f)(2) (emphasis added).

[17] 26 U.S.C. § 1398(f).

[18] The Bankruptcy Code defines the term "debtor" as a "person or municipality concerning which a case under this title has been commenced." 11 U.S.C. § 101(13)

[19] 11 U.S.C. § 726.

Susan's assumption that § 1398(f)(1) applied to the transfer of her interest in the community property to the Estate is simply wrong. As the government correctly points out, § 1398(f)(1) merely states the general rule that a transfer that would otherwise constitute a taxable disposition is nontaxable when the transferor is the debtor and the transferee is the estate. Here, in exchange for her transfer to the Estate, Susan received only the right to a future distribution; she did not have an "accession to wealth" at that time. The transfer was not, therefore, a taxable disposition, even absent the application of § 1398(f)(1). Hence, the corollary proposition urged by Susan – that she must be treated as a debtor for purposes § 1398(f)(2) – is baseless.[20]

We also conclude that § 1398(f)(2) is inapplicable to the facts of this case, principally because Susan never received a transfer of an asset from the Estate on termination of the Estate. Susan argues that, even though the

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[20] If she is not considered a debtor for purposes of § 1398(f)(2), contends Susan, then this section denies her the equal protection of the laws by treating filing and nonfiling spouses differently. Susan argues that she and Ken are similarly situated with respect to their community property interests, and that to make a distribution to one of them a nontaxable event while imposing tax on the other would be unconstitutional.

This argument is without merit. First, unlike Ken, Susan did not receive a "transfer" of "assets" from the bankruptcy estate on its "termination." In addition, unlike Ken, Susan retained a property interest in the community property even after it was transferred to the bankruptcy estate. She was, therefore, entitled to protect this interest by filing a claim against the estate. Consequently, the two are not similarly situated, and they need not be treated "equally" under the law.

distribution came from Tenneco rather than from the bankruptcy trustee, the $5.75 million should be deemed to have been transferred from the Estate pursuant to the "origin of the claim" doctrine. Under this doctrine, Susan advances, the taxability of income depends on the nature and character of the claim from which the money is derived. She contends that, in this particular instance, she was entitled to a tax-free distribution from the Estate, and that the payment from Tenneco was, in fact, a substitute for this distribution. Regardless of its immediate source, insists Susan, the payment should be treated no differently for tax purposes than one made directly from the Estate.

We are singularly unpersuaded by this argument. In support of her "origin of the claim" theory, Susan relies on cases in which courts have held that proceeds received "in lieu of" otherwise tax-exempt funds were themselves nontaxable.[21] In each of the cases cited, however, the

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[21] *See generally Lyeth v. Hoey*, 305 U.S. 188 (1938) (holding that an heir who contested his grandmother's will and who, as a result of a compromise of that contest, received property from the grandmother's estate which he would not have received had the will gone uncontested, acquired that property "by bequest, devise, or inheritance," and was therefore not liable for federal income taxes); *Early v. Commissioner*, 445 F.2d 166 (5th Cir. 1971) (holding that an agreement between taxpayers and heirs of decedent – pursuant to which taxpayers received a joint life interest in income from the trust estate in return for the surrender of stock allegedly gifted to them by the decedent – was actually a compromise of the taxpayers' disputed right to the stock, and since they claimed the stock as donees, they were to be treated as having acquired their life estate in that capacity for federal income tax purposes).

taxpayer received proceeds from an adverse party in settlement of an underlying, disputed claim.[22] In the instant case, Susan's claims were not settled; she sold her claims against Ken's estate to Tenneco for a $5.75 million payment. This payment did not operate to extinguish her underlying claims against the Estate; rather, it expressly transferred her claims to Tenneco. Consequently, regardless of whether Susan might have thought subjectively that this payment was in settlement of her claims – in lieu of a tax-free Estate distribution – the fact is inescapable that the $5.75 million payment is the proceeds of the sale of her unextinguished claims. Tenneco merely stepped into her shoes as claimant. In essence, Susan consciously chose to liquidate an asset – her claims against the Estate – by selling them for cash to a third party rather than retaining her claims and pursuing them at the risk of

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[22] Susan relies on *Estate of Longino v. Commissioner*, 32 T.C. 904 (1959) for the proposition that the origin of the claim doctrine can also be used to determine the taxability of proceeds received from third parties. In *Longino*, the taxpayers' cotton crop was destroyed through their use of a pesticide distributed by United Cooperatives, Inc. Taxpayers filed suit for damages against United and others who had had anything to do with the product. Taxpayers settled their claim with United for a payment of $21,087.60 from United's insurer. Because the insurer desired to preserve United's rights against the manufacturer and others, the settlement was handled by an assignment of taxpayers' claim in exchange for the settlement sum. The court held that, because the payment clearly represented damages for loss of profits – and not proceeds from a sale – the amount was taxable as ordinary income. *Id.* at 905-06. The holding in *Longino* is clearly inapposite to the instant case, in which Tenneco paid Susan $5.75 million for her claims against Ken's Estate, and not in settlement of those claims.

recovering less (or nothing) and at the expense of the time value of the money.

In addition, because the payment came from Tenneco rather than from the Estate, Susan obviously did not receive an "asset from the estate" as required under § 1398(f)(2). And, finally, there is the element of timing: Susan received the payment from Tenneco almost a year *before* distributions of the Estate's assets were made. Receipt of the payment prior to termination of the Estate is another reason why § 1398(f)(2) is not applicable.

2. Transfer in Satisfaction of Inchoate Marital Rights

In the district court, Susan also argued that the $5.75 million was exempt from tax under IRC § 1041. Section 1041 provides that property received from a former spouse incident to divorce is excluded from the recipient's gross income. The recipient's basis is equal to the transferor's basis, and the recognition of any gain or loss is deferred until the recipient transfers the property to a third party.[23] The district court rejected the applicability of § 1041 to the facts of this case, and Susan does not raise this argument again on appeal, thereby waiving it. On appeal, she relies instead on *United States v. Davis*,[24]

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[23] *Arnes v. United States*, 981 F.2d 456, 458 (9th Cir. 1992).

[24] *Davis* involved the transfer of appreciated stock by a husband to his former wife pursuant to a divorce decree in satisfaction of the wife's inchoate marital rights. The Supreme Court held that this transfer was a taxable event, that the value of the property received by the husband (the release of the wife's inchoate marital rights) was equal to the fair market

which governed the transfer of property in satisfaction of marital rights prior to the 1984 enactment of § 1041.

The Martins were divorced in 1991. Nevertheless, Susan argues that "[w]here § 1041 fails to apply and the Code does not provide substitute tax treatment, the tax treatment presumably is determined by common law doctrines – e.g., the *Davis* rule and, potentially, the assignment of income doctrine."[25]

Specifically, Susan asserts that Ken's filing of a bankruptcy petition converted her undivided one-half ownership interest in their community property into an inchoate interest in the Estate. Susan maintains that Ken had a legal obligation to reimburse her for her share of the marital assets. Had the payment come from her former husband in exchange for the release of this obligation, contends Susan, then, under Davis, he would be taxed on the gain, and she would take a basis equal to the face value of the cash distribution – $5.75 million.

In *Davis*, the Supreme Court assumed "that the parties acted at arm's length and that they judged the marital rights to be equal in value to the property for which they were exchanged."[26] As such, "the market value of the property transferred by the husband" was taken by the

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value of the stock, and that the husband must recognize gain on the transfer. The Court further held that the market value of the stock should be taken by the wife as her tax basis. 370 U.S. at 72-3.

[25] Quoting Cindy L. Wofford, "Divorce and Separation," 515 T.M. PORTFOLIOS, p. A-21 (BNA 1995).

[26] 370 U.S. at 72.

wife "as her tax basis for the property received."[27] Under the facts of this case, argues Susan, because the only asset available for distribution was cash, her tax basis is the face value of the payment she received. The fact that the payment came from Tenneco rather than from Ken, insists Susan, should not alter the tax consequences.

The district court rejected this argument, and so do we. Unlike the husband in *Davis*, Ken never transferred anything to Susan in discharge of his marital obligation. Instead, Susan accepted a cash payment from Tenneco in exchange for her claims against the Estate, almost a year before any distributions were made from the trustee and almost two years after her divorce. Had she waited for and received a distribution from the Estate, she might have been entitled to treat such distribution as a nontaxable payment incident to divorce, pursuant to IRC § 1041. As it stands, however, the transaction between Susan and Tenneco can be characterized as nothing other than a garden variety sale on which Susan recognized substantial and immediate gain.

The government takes the position that Tenneco purchased Susan's claims to limit its liability to her under the gas purchase contract. The fact that Ken or the Estate ultimately might have benefitted from this transaction, contends the government, is irrelevant. We agree. Despite Susan's attempt to convince us otherwise, the facts that the payment came to her from Tenneco and not Ken, that her claims were not satisfied or extinguished but continued to exist in the hands of the purchaser, and that she

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[27] *Id.* at 73.

was paid long before distributions were made by the Estate, have everything to do with the taxability of her payment. The government aptly notes that there is no evidence that Tenneco's payment was made at Ken's behest or that of his bankruptcy trustee, in exchange for a release of the claims under the gas purchase contract. Neither did Tenneco contract to buy Susan's claims against the Estate out of any concern for Ken or his marital property obligations. Susan's reliance on the Davis rule is wholly misplaced.

III

CONCLUSION

Susan has failed to demonstrate that the payment she received from Tenneco was excludable from her gross income either as a distribution from the Estate under § 1398(f)(2), or in satisfaction of her inchoate marital rights under Davis. Consequently, she must recognize gain on that transaction. And, as Susan has failed to establish any tax basis in her claims against the Estate, the gain that she must recognize is on the entire amount of the payment she received from the sale of these claims to Tenneco. The district court did not err in holding the entire $5.75 million taxable and denying Susan's claim for a refund of the taxes she paid on the transaction. For the foregoing reasons, the judgment of the district court is, in all respects,

AFFIRMED.

MINUTE ENTRY
McNAMARA, J.
AUGUST 22, 1997

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF LOUISIANA

SUSAN TAYLOR MARTIN	*	CIVIL ACTION
VERSUS	*	NO. 96-0889
UNITED STATES OF AMERICA	*	SECTION "D" (1)
	*	(Filed Aug. 22, 1997)

Before the court are the following motions:

(1) **Motion for Summary Judgment** filed by Plaintiff, Susan Taylor Martin; and

(2) **Cross-Motion for Summary Judgment** filed by the Government.

Both motions, set for hearing on July 16, 1997, are before the court on briefs, without oral argument.[1] Now, having considered the memoranda of counsel and the applicable law, the court finds that there is no genuine issue of material fact and the **Government** is entitled to judgment as a matter of law.

I. Background

The Government admits that Plaintiff's Statement of Uncontested Material Facts in support of her Motion for

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[1] The parties requested oral argument, but having reviewed the memoranda of counsel, the court finds that oral argument would not assist the court in deciding these motions.

Summary Judgment are true and correct. Thus, for purposes of giving the factual background of this litigation, the court now recites (with some modification) Plaintiff's Statement of Uncontested Material Facts:

(1) Ken Martin and Susan Martin were married in 1958 in Carbondale, Illinois; for many years prior to the events and transactions at issue here, they lived together in Louisiana.

(2) All property owned by Ken and Susan at any time material to this case was community property.

(3) In July 1990, Ken and Susan physically separated and, on August 27, 1990, Susan filed a suit for a judicial separation in state court.

(4) On February 19, 1991, Ken filed for protection under Chapter 7 of the United States Bankruptcy Code ("1991 Bankruptcy" or "1991 Estate"). Susan did not join in this petition, and became a "non-debtor" spouse.

(5) At the time of the filing of the 1991 Bankruptcy, the community property of Ken and Susan had not been partitioned.

(6) To protect her interests in the 1991 Estate, Susan timely filed Proof of Claim Number No. 6 and Amended Proof of Claim No. 12 in the bankruptcy proceedings of her husband.[2] Susan indicated on these Proof of

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[2] Copies of these claims can be found as Exhibits "A" and "A-1" attached to "Pre-Trial Brief of Susan Taylor Martin,

Claims that the basis of these claims was "spouse's undivided 1/2 interest in debtor's community." On her Amended Proof of Claim, she also asserted "claims for fraud, bad faith management of the community, breach of debtor's fiduciary duty, and any and all other delictual, contractual and quasi-contractual claims."

(7) On March 13, 1991, Ken and Susan were legally separated and were subsequently divorced on September 9, 1991.

(8) Although Ken listed no assets in his Petition for bankruptcy, Susan asserted that a very valuable asset of the community estate was a contract that existed between one of the many corporations formed by Ken, namely Martin Intrastate Gas Company (MIG), and Louisiana Intrastate Gas Company (LIG). At the time the contract was entered into, LIG was a subsidiary of Tenneco, Inc. The contract required that LIG purchase very large quantities of gas at a fixed price, which price was (at all times pertinent to the transactions herein) quadruple the market price. Although Tenneco, Inc. later sold all of its interest in LIG, it became the indemnitor to and for LIG for all liability and/or performance under the contract ("Gas Purchase Contract"). Tenneco Gas Louisiana, Inc. ("Tenneco") is a subsidiary of Tenneco, Inc. and

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Adversary No. 93-1199," all of which are attached to the Government's Response to Plaintiff's Motion for Partial Summary Judgment in this record as Doc. No. 13.

it entered into all of the agreements relevant to this matter.

(9) Although Tenneco contested the validity and ownership of the Gas Purchase Contract in the appropriate Louisiana state courts, Tenneco recognized that, if the contract was valid, it was a very valuable asset to its holder and it created a substantial liability on the part of Tenneco.

(10) Tenneco sought to eliminate or, at least, limit its liability under the Gas Purchase Contract by acquiring any and all interests in the Gas Purchase Contract that were held or purportedly held by the various parties asserting rights to the contract. These parties included the Trustee of a 1982 bankruptcy proceeding filed by Ken and Susan,[3] the Trustee of the 1991 Estate and all entities formed by Ken in an attempt to obfuscate and disguise his de facto ownership interest in and control of the Gas Purchase Contract.

(11) On June 14, 1993, Tenneco acquired an option to buy any rights in and to the Gas Purchase Contract from the 1982 Bankruptcy Trustee.

(12) On July 1, 1993, Susan and Tenneco executed an Acquisition Agreement dated June 29, 1993, under which Tenneco paid Susan $5,750,000.00 to acquire her claims

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[3] In 1982, Ken and Susan jointly filed a petition with the U.S. Bankruptcy Court for protection under Chapter 11 of the Bankruptcy Code. Sometime thereafter, this case was converted to a Chapter 7 and Robert Marrero was appointed as Trustee.

against the 1991 Bankruptcy of her former husband, Ken.[4]

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[4] The Acquisition Agreement states in pertinent part:

1.1 Purchase of Property Upon and subject to the terms and conditions of this Agreement, Tenneco agrees to purchase, and Susan agrees to sell, convey, assign and deliver, at the Closing . . . for the Purchase Price . . . all direct and indirect rights, titles, interests and claims of Susan Martin now owned or hereafter acquired in and to any part or all of:

(a) the Purported Contract Rights,

(b) the community property of Susan Martin and Ken Martin,

(c) property jointly owned by Susan Martin and the 1991 Estate,

(d)-(o) [various stocks and claims]

(all such rights, titles, interests and claims being hereinafter referred to as the "Property"). It is expressly agreed by Susan Martin that Tenneco is not assuming any liability of Susan Martin, any such liability being expressly retained by Susan Martin, and the Property when transferred to Tenneco pursuant to this Agreement shall not be subject to any liability, except the Permitted Encumbrances (as hereinafter defined).

1.2 Amount of Purchase Price. The purchase price of the Property . . . shall be $5,750,000.

. . .

4.4 Permitted Encumbrances. For purposes of this Agreement, the term "Permitted Encumbrances" shall mean . . . (iv) the provisions of the Bankruptcy Code Section 541 that make the community property of Susan Martin and Ken Martin property of the 1991 Estate and thereby make the interest of Susan Martin subject to the community liabilities reflected in the

(13) On July 9, 1993, the Trustee of the 1991 Bankruptcy Estate filed an adversary proceeding (No. 93-1199-JAB) claiming that the $5,750,000 received by Susan from Tenneco was property of the 1991 Estate.

(14) The Bankruptcy Court (Judge Jerry A. Brown) in Adversary Proceeding No. 93-1199-JAB (per its November 17, 1993 Decision) ruled against the Trustee and found that Susan could not sell and did not sell assets of the estate to Tenneco. Rather, pursuant to the Acquisition Agreement executed between Susan and Tenneco, Susan sold only her interest in the 1991 Bankruptcy Estate of Ken, whether it was her interest as a creditor or her claim against the estate for her former one-half interest of the community property that had become property of the estate under 11 U.S.C. § 541(a)(2).

(15) On July 2, 1993 (the day after the Acquisition Agreement was executed), Tenneco and the Trustee of the 1991 Bankruptcy Estate executed a Settlement Agreement through which Tenneco paid $7,000,000 to the Trustee for an option to buy the Gas Purchase Contract. Thus, unlike the vast majority of bankruptcy cases, the 1991 Bankruptcy Estate became solvent.

1991 Case, but only to the extent of the community liabilities and the claims against such community property referenced above in this Section 4.4. . . .

(See Acquisition Agreement, Plaintiff's Exhibit No. 4).

(16) After the transactions of June 14, July 1 and July 2, 1993, Tenneco owned options to acquire the Gas Purchase Contract from both the 1991 Bankruptcy Estate and the 1982 Bankruptcy Estate, and also owned Susan Martin's claims against the 1991 Bankruptcy Estate for any possible distributions to which Susan might be entitled.

(17) The Trustee of the 1991 Bankruptcy reported the sale of the Purported Gas Purchase Contract Rights to Tenneco on the Estate's timely filed 1992 federal income tax return. The correctness of that return is not before this court.

(18) An Amendment to the Settlement Agreement ("Amendment") was executed on March 3, 1994, by and between Jean Turner, Trustee of the 1991 Estate, and Tenneco.[5] This Amendment recites the various settlements, claims, and counterclaims among all of the parties in interest. The Amendment and the various releases executed pursuant to it both (a) settled all outstanding claims each party had against all other parties in the various suits over the Gas Purchase Contract as well as other claims in the 1991 Estate and (b) effected a distribution of all the assets in the 1991 Estate. The Bankruptcy Court approved this Amendment.

(19) Pursuant to the Amendment, Tenneco agreed to distributions by the 1991 Trustee

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[5] Other parties to this Amendment included the 1982 Bankruptcy Estate and its Trustee, Robert Marrero; Ken Martin; and Susan Martin.

> of all the property of the 1991 Estate, including distributions to the debtor, without any distribution to itself in satisfaction of the Susan Martin claims.

Susan timely filed her tax return for the period ending December 1993, and attached Form 8275, setting forth her reasons why the $5,750,000 received pursuant to the Acquisition Agreement was not taxable. The Government disagreed, and on February 5, 1996, Susan paid the taxes due and she also filed a refund claim. On March 11, 1996, the Government disallowed the refund claim, and on March 12, 1996, Susan filed this suit to recover the refund.

In this litigation, Susan first filed a Motion for Partial Summary Judgment on the issue of "what" she sold to Tenneco through the Acquisition Agreement. Susan argued that she did not sell any direct interest in community property, but only assigned for cash consideration her claims against her husband's bankruptcy estate. On the other hand, the Government argued that Susan also transferred her interest in many items that were among the assets of the community between Ken and Susan.

This court granted Susan's motion and held (as had Judge Brown in Adversary Proceeding No. 93-1199-JAB) that Susan sold only her interest in the 1991 Bankruptcy Estate of Ken, whether it was her interest as a creditor or her claim against the estate for her former one-half interest of the community that had become property of the estate under 11 U.S.C. § 541(a)(2). (*See* Minute Entry dated November 21, 1996, Doc. No. 15).

II. Legal Analysis

A long-standing principle of federal tax law is that, absent an enumerated exception, gross income means all income from whatever source derived. 26 U.S.C. § 61(a); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430, 75 S.Ct. 473, 476, 99 L.Ed.2d 483 (1955). "Accessions to wealth are generally presumed to be gross income unless the taxpayer can show that the accessions falls within a specific exclusion. Exclusions from income are to be construed narrowly." *Wesson v. United States*, 49 F.3d 894, 898 (5th Cir. 1995).

Further, a taxpayer ordinarily cannot "avoid the consequences of [her] agreement by showing that the 'economic realities' were otherwise." *Smith v. C.I.R.*, 65 F.3d 37, 40 (5th Cir. 1995) (citation omitted). Rather,

> while a taxpayer is free to organize [her] affairs as [she] chooses, nevertheless, once having done so, [she] must accept the tax consequences of [her] choice, whether contemplated or not, and may not enjoy the benefit of some other route [she] might have chosen to follow but did not.

Id. quoting, Commissioner of Internal Revenue v. National Alfalfa Dehydrating & Miller Co., 417 U.S. 134, 94 S.Ct. 2129, 40 L.Ed.2d 717 (1974).

In her Motion for Summary Judgment, Susan argues that $5,750,000 which Tenneco paid her is not taxable because:

(1) as a non-filing spouse in community, Tenneco's payment of the $5,750,000.00 to her constituted an after-tax return of the proceeds from the 1991 Bankruptcy Estate

under IRC § 1398 and the Bankruptcy Code. (Should IRC § 1398 apply, Susan further argues that there is no issue of proper basis because she did not transfer an asset of the bankruptcy estate, but rather a claim to after-tax proceeds);

(2) If IRC § 1398 is inapplicable, then IRC § 1041 applies to shield the transaction from tax because the payment constituted a receipt of property incident to her divorce. (Should IRC § 1041 apply, Susan further argues that she is deemed to have received cash from Ken in a transaction which is tax-free to her); and

(3) If IRC § 1041 is inapplicable, then the pre-§ 1041 rule of *United States v. Davis*, 370 U.S. 65, 82 S.Ct. 1190, 8 L.Ed.2d 335 (1962), should apply to deem the transaction a tax-free payment in satisfaction of Susan's inchoate marital rights. (Should *Davis* apply, Susan further argues that the basis of the property which the transferee spouse receives is equal to its fair market value on the date of the transfer).

The problem with each of these arguments is that the facts of this case do not fit the legal basis under which the argument is raised. Further, the court rejects Susan's use of the "origin of claims doctrine" to twist the facts in an attempt to make them fit.[6]

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[6] Susan maintains that the "origin of the claim doctrine" is a long established principle of tax law, under which "both the taxpayer and the Internal Revenue Service must look to the source, origin, nature and character of the claim to determine

A. Plaintiff's "IRC § 1398" Argument

In making her ***first argument***, Plaintiff relies on IRC § 1398(f)(2) which states:

> **Transfer from estate to debtor not treated as disposition.** – In the case of a termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the debtor shall be treated as the estate would be treated with respect to such asset.

28 U.S.C. § 1398(f)(2).

However, this provision is inapplicable here because:

(1) § 1398 applies only to a "debtor" which is defined by the Bankruptcy Code as a "person or municipality concerning which a case under [Title 11, U.S.C.] has been commenced. 11 U.S.C. § 101(13). Here, Susan was a "non-filing spouse," which does not equate to a bankruptcy "debtor". The court finds no merit in Susan's arguments (including her arguments based on equal protection and the historical definition of "debtor") that she should be considered a

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the taxability of proceeds from the transfer of the claim or the deductibility of the costs relating to the claim." (*See* Plaintiff's memo., p. 14).

While this court recognizes that the "origin of the claim doctrine" certainly has application in the appropriate tax case setting, the court finds that Susan's attempted application of this doctrine in this tax case is inappropriate.

"debtor" just as her filing spouse was considered a debtor;

(2) there was no transfer of an "asset", but rather the transaction was a sale of Susan's "claim against the estate". When the Acquisition Agreement was executed, Susan did not own any assets of the estate; and

(3) Susan did not receive the $5.75 million from the "estate" but from "Tenneco". Susan contends that Tenneco's acquisition of her claim, which was shortly followed by Tenneco's acquisition of an option to buy the Purported Gas Purchase Contract Rights held by the 1991 Bankruptcy Estate, was part of a single, unified plan of Tenneco to acquire all rights to the contract. Thus, Susan concludes that she sold nothing more than her "claim or right to a distribution of proceeds from the sale of bankruptcy property [i.e ., the sale of the Purported Gas Purchase Contract Rights] after payment of all administrative expenses, taxes and creditors." (See Plaintiff's Reply Memo., p. 4, 6, 7 and Plaintiff's Orig. Memo., p. 13).

However, this court is unpersuaded by Susan's argument based on the "origin of the claim doctrine"[7] and refuses to hold that a distribution from a *third-party* (here, Tenneco)

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[7] In urging her "origin of claim doctrine" argument, Susan argues that:

> The funds [she received from Tenneco] constituted nothing more than a payment by Tenneco of what [she] would have been entitled to at the conclusion of

> amounts to the same thing as a distribution from a *bankruptcy estate*, and is tax-free. Rather, to fall within the protection of IRC § 1398(f)(2), Susan would have had to take her distribution from the 1991 bankruptcy estate as a non-filing spouse.

B. Plaintiff's "IRC § 1041" Argument

In making her ***second argument***, Plaintiff assumes that IRC § 1398 is inapplicable and relies on IRC § 1041(a)(2) which states:

> No gain or loss shall be recognized on a transfer of property from an individual to a former spouse, but only if the transfer is incident to the divorce.[8]

26 U.S.C. § 1041(a)(2).

> the bankruptcy proceeding. There was only one **asset** and that asset was sold by the 1991 Trustee; any gain on this sale was properly reportable by the 1991 Trustee. [She] at no time owned anything other than **rights** under the **claims** she had filed; these rights were **rights** to a distribution of after-tax proceeds of the sale of the Purported Gas Purchase Contract Rights. [She] sold her rights to this distribution to Tenneco and the origin of the claim doctrine protects this transfer from what would be a double tax on the sale of a single **asset**.

(See Plaintiff's Reply Memo., p. 4).

While Susan maintains, and this court has found, that she did not sell an interest in assets of the 1991 Bankruptcy, but rather transferred only her claims against the 1991 Bankruptcy, the court finds that her attempted use of the "origin of claims doctrine" obfuscates the distinction between "claim," "right," and "asset."

[8] A transfer of property is incident to the divorce if such transfer is related to the cessation of the marriage. 26 U.S.C. § 1041(c)(2).

The purpose of this provision is to defer the tax consequences of transfers between spouses or former spouses. *Arnes v. United States*, 981 F.2d 456, 458 (9th Cir. 1992), *citing*, H.R.Rep. No. 432, Pt. II, 98th Cong., 2d Sess. 1491 (1984), reprinted in 1984 *U.S. Code Cong. & Admin.News* 697, 1134.[9] As one court has explained:

> Property received in such a transfer is excluded from the recipient's gross income. The recipient's basis is then equal to the transferor's basis. 26 U.S.C. § 1041(b)(2). Later, when the recipient transfers the property to a third party, the gain or loss must be recognized.

Arnes, 981 F.2d at 448.

However, this provision is inapplicable here because:

(1) While § 1041 was designed to make transactions between divorcing spouses tax-free when one spouse transfers marital property to the other incident to divorce, Susan did not receive property from her ex-husband or any asset from his bankruptcy estate. Instead, she received money from Tenneco (an unrelated third-party outside the marital unit) for her separate claim against the bankruptcy estate, and any community property remained an asset of the 1991 Estate. The sale was not made pursuant to the to [sic] Ken's written request, written consent or ratification;

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[9] The basic policy of § 1041 is to treat a husband and wife as one economic unit, and to defer, but not eliminate, the recognition of any gain or loss on interspousal property transfers until the property is conveyed to a third party outside the economic unit. *Blatt v. Commissioner*, 102 T.C. 77 (1994).

(2) Susan attempts to jump this hurdle by relying on Treas. Temp. Reg. § 1.1041-1T, and a case construing this regulation, *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992).

Susan specifically relies on Q-A, A-9 of Treas. Temp. Reg. § 1.1041-1T[10]] which explains that in certain cases a transfer of property to a *third party* may be tax-free if the transfer was made "on behalf of" a spouse or former spouse, *and the transfer is required by a divorce or separation instrument*. However, the regulation contemplates that the property transferred must be marital property (i.e., property in which one or both spouses had an interest prior to the transfer) and again, Susan did not transfer any marital property, as that remained an asset of the estate. What she sold to Tenneco was her separate claim against the estate.

Further, in July 1993, when Susan received her payment from Tenneco, there was no requirement in any divorce or separation instrument requiring the payment. She entered the Acquisition Agreement only with Tenneco and

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[10] While Susan initially relies on this Temporary Regulation when she sets forth her IRC § 1041 argument in her **Original** memorandum (pp. 21-30), she later crayfishes away from this reliance in her **Reply** Memorandum (p. 9) when she states:

> to the extent this Court determines that the Plaintiff did not fit the technical parameters of the government's temporary regulations, then Plaintiff respectfully submits that the temporary regulation, an interpretative regulation, does not harmonize with the plain language of IRC § 1041, its origin, or its purpose.

gave up her claims against the estate for a cash payment from Tenneco.

Susan argues that the Amendment to the Settlement Agreement (dated March 3, 1994) "effected a property settlement between Ken Martin and Susan Martin in satisfaction of her claims against the 1991 Bankruptcy Estate" and thus, "the Amendment constitutes the divorce or separation instrument required by the Temporary Regulation." (Plaintiff's memo., p. 22).[11]

However, the date of this Amendment, March 3, 1994, was some eight months *after* the

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[11] Susan more fully argues that:

> [She] lost her ownership interest in the property of the former community when Ken Martin filed for bankruptcy. 11 U.S.C. 541(a)(2). What she received from Tenneco was a transfer which ultimately was for the benefit of Ken Martin's 1991 Bankruptcy Estate. The Amendment to Settlement Agreement approved by the Bankruptcy Court acts as a divorce or separation agreement in which Ken Martin and the Bankruptcy Trustee of the 1991 Bankruptcy recognized the transfer from Tenneco to Susan Martin. Further, through the Amendment, Tenneco subordinated its claim in favor of Ken Martin, thus releasing him from any further obligation for Susan Martin's claims. The acquisition by Tenneco of the Susan Martin claims and the later subordination by Tenneco which benefitted Ken Martin's 1991 Bankruptcy Estate constitute a transfer contemplated by IRC § 1041. Any taxes due on the sale of the asset to Tenneco by the 1991 Bankruptcy Estate should be borne by the Estate.

(*See* Plaintiff's Memo., p. 30). The court finds that in making this argument, Susan again twists the facts into something that they are not.

Acquisition Agreement was executed. And nowhere in this global settlement is there any agreement between Ken and Susan that Tenneco's earlier $5.75 million payment to Susan would be treated as a transfer under § 1041.

Finally, the sale to Tenneco was not made "on behalf of" Ken because no obligation or liability of Ken's was satisfied by the sale. *Arnes*, 981 F.2d at 459. Susan's claim to community property still existed as before the sale, only it was vested in Tenneco, an unrelated third party.

C. Plaintiff's "Davis" Argument

In making her ***third argument***, Plaintiff assumes § 1041 inapplicable and relies on the case of *United States v. Davis*, 370 U.S. 65, 82 S.Ct. 1190, 8 L.Ed.2d 335 (1962), which governed the transfer of property in satisfaction of marital rights prior to the enactment of IRC § 1041 in 1984.[12]

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[12] In 1984, *Davis* was legislatively overruled by the enactment of 26 U.S.C. § 1041. However, *Davis* has been applied when the effective date of the divorce in question preceded the date 28 U.S.C. § 1041 was enacted. *See e.g., Cook v. United States*, 904 F.2d 107 (1st Cir. 1990).

In this case, the Martins were divorced in 1991, which was after the date of the enactment of § 1041. However, Susan argues "where § 1041 fails to apply and the Code does not provide substitute tax treatment, the tax treatment presumably is determined by common law doctrines – e.g., the *Davis* rule and, potentially, the assignment of income doctrine." (Plaintiff's Memo., p. 31, *quoting*, Wofford, 515 T.M., *Divorce and Separation*, p. A-21). However, again, the court finds that Susan is attempting to fit a square peg into a round hole.

In *Davis*, the taxpayer husband transferred, pursuant to a property settlement agreement executed prior to divorce, appreciated shares of stock to his former wife for relinquishment of her inchoate marital rights. (Under the law in Delaware, where the divorcing couple lived, all of the property transferred was that of the husband subject to certain statutory marital rights of the wife.) The Supreme Court recognized this transfer as a taxable transfer as to the husband and based the taxable gain on the value of the stock on the date of its transfer. *Davis*, 82 S.Ct. at 1195.

The Court also stated that: "the same calculation that determines the amount received by the husband fixes the amount given up by the wife, and this figure, i.e., the market value of the property transferred by the husband, will be taken by her as her tax basis for the property received." *Davis*, 82 S.Ct. at 1195.

In her *Davis* argument, Susan claims that she sold only inchoate marital rights which replaced her ownership interest in the community property by operation of law when Ken filed for bankruptcy in September 1991, and the basis of these inchoate marital rights is deemed equal to the value of the cash received. However, the court declines to apply the rule of *Davis* to the facts of this case because there are significant factual distinctions.

In *Davis*, the husband transferred corporate stock to his former wife in discharge of marital obligations. Here, however, there was no transfer from ex-husband Ken to Susan, but rather a cash payment by third-party Tenneco to Susan for her claims against Ken's 1991 bankruptcy estate. Further, the court will not allow these facts to be

distorted under an attempted use of the "origin of claims doctrine" to make this case fit *Davis*.

III. Conclusion

Susan cannot escape the fact that she received the $5.75 million from Tenneco for the sale of her claims against Ken Martin's 1991 Bankruptcy Estate. Try as she might, she cannot twist these facts into: a distribution from the bankruptcy estate to fall within IRC § 1398; a payment from her ex-husband to fall under IRC § 1041; or the sale of an inchoate marital right under *Davis*.

Further, because Susan sold to Tenneco her claims against the bankruptcy estate, she must recognize gain unless her basis in the claim was equal to or greater than the amount she received. However, because her claims against the bankruptcy estate had no basis, she must pay tax on the entire $5.75 million received from Tenneco.

Accordingly;

IT IS ORDERED that the **Motion for Summary Judgment** filed by Plaintiff, Susan Taylor Martin, be and is hereby **DENIED**, and the **Cross-Motion for Summary Judgment** filed by Defendant, the United States of America, be and is hereby **GRANTED.**

* * *

MINUTE ENTRY
McNAMARA, J.
NOVEMBER 20, 1996

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF LOUISIANA

SUSAN TAYLOR MARTIN	*	CIVIL ACTION
VERSUS	*	NO. 96-0889
UNITED STATES OF AMERICA	*	SECTION "D" (1)
	*	(Filed Nov. 21, 1996)

Before the court is the **"Motion for Partial Summary Judgment"** filed by Plaintiff, Susan Taylor Martin, and set for hearing on Wednesday, November 20, 1996. The Defendant, the United States of America, filed a memorandum in opposition.

Having considered the memoranda and argument of counsel and the applicable law, the court finds that the motion should be granted because there are no genuine issues of material fact and as a matter of law, Susan Martin, pursuant to the Acquisition Agreement executed between Tenneco Gas Louisiana, Inc., sold only her interest in the 1991 bankruptcy estate of Kenneth Martin, whether it was her interest as a creditor or her claim against the estate for her former one-half interest of the community property that had become property of the estate under 11 U.S.C. 541(a)(2).[1]

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[1] This ruling is made as a matter of law, and the court rejects Plaintiff's arguments that the 1991 Trustee was an agent of the Government and that this court is bound by Judge Jerry

However, nothing in this ruling should be construed as a finding or conclusion that this transaction was taxable or non-taxable, and *if* it was taxable, what the basis is. Accordingly;

IT IS ORDERED that Plaintiff's **"Motion for Partial Summary Judgment"** be and is hereby **GRANTED** to the extent that the court concludes as a matter of law that, pursuant to the Acquisition Agreement executed between Tenneco Gas Louisiana, Inc., Susan Martin sold only her interest in the 1991 bankruptcy estate of Kenneth Martin, whether it was her interest as a creditor or her claim against the estate for her former one-half interest of the community property that had become property of the estate under 11 U.S.C. 541(a)(2).

* * *

Brown's Decision in the Adversary Proceeding, No. 93-1199-JAB, filed by the 1991 Trustee against Susan Martin Taylor.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 97-31277

SUSAN TAYLOR MARTIN

Plaintiff-Appellant

v.

UNITED STATES OF AMERICA

Defendant-Appellee

Appeal from the United States District Court for the Eastern District of Louisiana, New Orleans

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ON PETITION FOR REHEARING

(Filed Jan. 13, 1999)

Before WIENER, BARKSDALE and EMILIO M GARZA, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above case is denied.

ENTERED FOR THE COURT:

/s/ Jacques Wiener
United States Circuit Judge

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11 U.S.C. § 541

UNITED STATES CODE
TITLE 11. BANKRUPTCY
CHAPTER 5 – CREDITORS, THE DEBTOR, AND THE ESTATE
SUBCHAPTER III – THE ESTATE

Current through P.L. 105-220, approved 8-7-1998

§ 541. Property of the estate

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

(2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is –

(A) under the sole, equal, or joint management and control of the debtor; or

(B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

. . .

11 U.S.C. § 726

UNITED STATES CODE
TITLE 11. BANKRUPTCY
CHAPTER 7 – LIQUIDATION
SUBCHAPTER II – COLLECTION, LIQUIDATION, AND DISTRIBUTION OF THE ESTATE

Current through P.L. 105-220, approved 8-7-1998

§ 726. Distribution of property of the estate

(a) Except as provided in section 510 of this title, property of the estate shall be distributed –

(1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title, proof of which is timely filed under section 501 of this title or tardily filed before the date on which the trustee commences distribution under this section;

(2) second, in payment of any allowed unsecured claim, other than a claim of a kind specified in paragraph (1), (3), or (4) of this subsection, proof of which is –

(A) timely filed under section 501(a) of this title;

(B) timely filed under section 501(b) or 501(c) of this title; or

(C) tardily filed under section 501(a) of this title, if –

(i) the creditor that holds such claim did not have notice or actual knowledge of the case in time for timely filing of a proof of such claim under section 501(a) of this title; and

(ii) proof of such claim is filed in time to permit payment of such claim;

(3) third, in payment of any allowed unsecured claim proof of which is tardily filed under section 501(a) of this title, other than a claim of the kind specified in paragraph (2)(C) of this subsection;

(4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;

(5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and

(6) sixth, to the debtor.

. . .

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26 U.S.C. § 1398

UNITED STATES CODE
TITLE 26. INTERNAL REVENUE CODE
SUBTITLE A – INCOME TAXES
CHAPTER 1 – NORMAL TAXES AND SURTAXES
SUBCHAPTER V – TITLE 11 CASES

Current through P.L. 105-220, approved 8-7-1998

§ 1398. Rules relating to individuals' title 11 cases

. . .

(f) Treatment of transfers between debtor and estate. –

(1) Transfer to estate not treated as disposition. – A transfer (other than by sale or exchange) of an asset from the debtor to the estate shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the estate shall be treated as the debtor would be treated with respect to such asset.

(2) Transfer from estate to debtor not treated as disposition. – In the case of a termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the debtor shall be treated as the estate would be treated with respect to such asset.

. . .

Supreme Court, U.S.
FILED
MAY 11 1999
CLERK

No. 98-1639

In the Supreme Court of the United States

SUSAN TAYLOR MARTIN, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the payment received by petitioner from a third party for the sale of her claims against a bankruptcy estate is exempt from tax as a transfer of "an asset from the estate to the debtor" under Section 1398(f)(2) of the Internal Revenue Code, 26 U.S.C. 1398(f)(2).

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In the Supreme Court of the United States

No. 98-1639

SUSAN TAYLOR MARTIN, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-14) is reported at 159 F.3d 932. The opinion of the district court (Pet. App. 15-33) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on November 12, 1998. The petition for rehearing was denied on January 13, 1999 (Pet. App. 36). The petition for a writ of certiorari was filed on April 12, 1999. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner married Ken Martin 1958. They lived in Louisiana prior to their legal separation and divorce

in 1991, and all of the property that they possessed while married was community property (Pet. App. 2).

On February 19, 1991, Ken Martin filed a petition for relief under Chapter 7 of the Bankruptcy Code. Petitioner did not join in the petition. Since her husband's bankruptcy petition was filed prior to any legal partition of the community property, the community property became part of her husband's bankruptcy estate under 11 U.S.C. 541(a). To protect her interest in the community property, petitioner filed a proof of claim in the bankruptcy case in which she asserted an "undivided 1/2 interest in debtor's community" (Pet. App. 2-3 n.3). In an amended proof of claim, she further asserted "claims for fraud, bad faith management of the community, breach of [the] debtor's fiduciary duty, and any and all other delictual, contractual and quasi-contractual claims" (*ibid.*).

One valuable asset of the community estate was a gas purchase contract held by Martin Interstate Gas Company, a company formed and wholly owned by Ken Martin (Pet. App. 3 n.4). The contract required Louisiana Interstate Gas Company to purchase large quantities of natural gas at a specified price that was substantially higher than the prevailing market price (*ibid.*). Tenneco, Inc., which had guaranteed the buyer's performance under the gas purchase contract (*ibid.*), recognized that it would have substantial liability under the contract. It therefore sought to acquire the interests of all parties asserting rights thereunder (*id.* at 18). Those parties included petitioner and the trustee of her husband's bankruptcy estate (*ibid.*).

On July 1, 1993, Tenneco entered into an agreement with petitioner under which it paid her $5.75 million in exchange for her release of her claims under the gas purchase contract and her conveyance to Tenneco of all

of her claims against her husband's bankruptcy estate (Pet. App. 18-19). On July 2, 1993, Tenneco entered into an agreement with the trustee of her husband's bankruptcy estate under which the trustee was paid $7 million for an option to purchase the estate's rights under the gas purchase contract (*id.* at 20).

On July 9, 1993, the trustee of the bankruptcy estate commenced an adversary proceeding in which it claimed that the $5.75 million that Tenneco had paid to petitioner was property of the estate (Pet. App. 20). Petitioner argued that she could not and did not sell to Tenneco any assets belonging to her husband's bankruptcy estate. The bankruptcy court agreed, holding that petitioner sold to Tenneco only her personal interest as a claimant against the bankruptcy estate (*ibid.*).

On March 3, 1994, Tenneco and the trustee of her husband's bankruptcy estate amended the July 2, 1993, agreement to provide a release of all outstanding claims by each party to the various lawsuits concerning the gas purchase contract and to effect a distribution of all of the assets in the bankruptcy estate (Pet. App. 21). No distribution was ever made from the estate to Tenneco in satisfaction of the claims that it had acquired from petitioner (*id.* at 21-22).

2. The trustee of the bankruptcy estate reported the $7 million payment from Tenneco on the estate's federal income tax return for its fiscal year 1992 (Pet. App. 20, 22). Although petitioner disclosed the $5.75 million payment from Tenneco on her federal income tax return for the year 1993, she took the position that the payment was not subject to tax. The Internal Revenue Service audited her return and determined that the payment constituted taxable income. Petitioner paid the resulting taxes and interest and brought this refund suit in district court (*ibid.*). She contended that the

payment she received from Tenneco was excluded from tax under Section 1398(f)(2) of the Internal Revenue Code on the theory that it constituted a transfer "of an asset from the estate to the debtor" (26 U.S.C. 1398(f)(2)).[1]

The district court granted the government's motion for summary judgment (Pet. App. 34-35). Noting that all income from any source is presumptively taxable, the court concluded that petitioner had failed to demonstrate that the $5.75 million payment from Tenneco falls within any specific exclusion from tax under the Internal Revenue Code (*id.* at 23). The court ruled, in particular, that Section 1398(f)(2) of the Internal Revenue Code does not apply to this case because petitioner was not a "debtor" to whom that exclusion applies. Instead, petitioner "was a 'nonfiling spouse,' which does not equate to a bankruptcy 'debtor'" (*id.* at 25). Moreover, "there was no transfer of an 'asset,' but rather the transaction was a sale of [petitioner's] claim against the [bankruptcy] estate" and petitioner "did not receive the $5.75 million from the 'estate' but from 'Tenneco'" (*id.* at 26). Because this

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[1] Petitioner contended in the alternative that, under the rationale of *United States* v. *Davis*, 370 U.S. 65 (1962), the payment from Tenneco should be viewed as if it were a taxable sale of marital property by her husband's bankruptcy estate to petitioner followed by a sale of that property by petitioner to Tenneco. The district court and the court of appeals rejected that contention (Pet. App. 13, 31-33), and petitioner has not raised that claim in her petition in this case.

Petitioner also argued in the district court that the payment was excluded from her income under Section 1041 of the Internal Revenue Code as a transfer of property between spouses incident to divorce (Pet. App. 24, 27-31). She waived that contention in the court of appeals (*id.* at 11), however, and has not renewed it here.

case involves the sale of an asset by a non-debtor to a third-party, and does not involve the transfer of an asset from the estate to the debtor, the exclusion from tax provided by Section 1398(f)(2) is "inapplicable here" (*id.* at 25).

3. The court of appeals affirmed (Pet. App. 1-14). The court concluded that Section 1398(f)(2) "is inapplicable to the facts of this case" because petitioner "never received a transfer of an asset from the Estate on termination of the Estate" (*id.* at 8). The court held that the "origin of the claim doctrine" does not apply to recharacterize the $5.75 million payment from Tenneco to petitioner as a payment in satisfaction of petitioner's marital claims against the bankruptcy estate (*id.* at 9-11). The court explained that petitioner's claims against the bankruptcy estate "were not settled; * * * th[e] [payment from Tenneco] did not extinguish her underlying claims * * * ; rather, it expressly transferred her claims to Tenneco" (*id.* at 10).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. In a liquidation or reorganization under the Bankruptcy Code, the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case" (11 U.S.C. 541(a)(1)) as well as the "[p]roceeds * * * or profits of or from property of the estate" (11 U.S.C. 541(a)(6)). See *In re Graham*, 726 F.2d 1268 (8th Cir. 1984). The bankruptcy estate formed by the commencement of a bankruptcy case is a separate taxable entity; it is directly liable for any taxes owed with respect to the items of income that it

receives. 26 U.S.C. 1398. See *In re Kochell*, 804 F.2d 84, 87 (7th Cir. 1986).

Because the bankruptcy estate is itself to pay the tax owed on the income it receives, Section 1398(f)(2) of the Internal Revenue Code provides that, on "termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor" is to be treated as a tax-free exchange. 26 U.S.C. 1398(f)(2). See *In re Terjen*, 154 B.R. 456, 458 (Bankr. E.D. Va. 1993), aff'd, 30 F.3d 131 (4th Cir. 1994). This statute thereby avoids a double tax on the items of income already subjected to tax in the hands of the bankruptcy estate.

As the courts below correctly concluded (Pet. App. 8-10, 25-26), Section 1398(f)(2) does not apply to this case. That Section applies only to transfers "from the estate to the debtor." Petitioner, who neither filed nor joined in the bankruptcy petition, plainly was not a "debtor" in the bankruptcy case. See 11 U.S.C. 101(13); *In re Kastner*, 197 B.R. 620, 623-624 (Bankr. E.D. La. 1996). Moreover, as the court of appeals observed, petitioner "never received a transfer of an asset from the Estate on [the] termination of the Estate" (Pet. App. 8). Instead, she received a payment of $5.75 million from Tenneco almost one year prior to the termination of Ken's bankruptcy estate (*id.* at 11).[2]

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[2] The present case involves a factually unique situation—the purchase by an unrelated party of the nonfiling spouse's claims against a bankruptcy estate. Notwithstanding petitioner's suggestion that the number of nonfiling spouses whose interest in community property is transferred to their spouses' bankruptcy estate is "probably substantial, perhaps in the thousands" (Pet. 11), we are unaware of any similar pending cases. The specific issue presented in this case is unlikely to recur with any frequency, if at all.

2. a. Petitioner contends (Pet. 12-17) that, under the "origin of the claim doctrine," the payment that she received from Tenneco should be recharacterized as a payment from her husband's bankruptcy estate. Under the "origin of the claim doctrine," amounts received in settlement of a claim are treated for tax purposes as having the same character as the claim itself. See, *e.g.*, *Helvering* v. *Safe Deposit Co.*, 316 U.S. 56 (1942); *Lyeth* v. *Hoey*, 305 U.S. 188 (1938); *Early* v. *Commissioner*, 445 F.2d 166 (5th Cir.), cert. denied, 404 U.S. 855 (1971); *Raytheon Production Corp.* v. *Commissioner*, 144 F.2d 110, 113 (1st Cir.), cert. denied, 323 U.S. 779 (1944). Petitioner errs, however, in asserting (Pet. 11) that the payment she received from Tenneco released her husband's bankruptcy estate from petitioner's marital claims and should therefore be treated as a nontaxable distribution from the bankruptcy estate to petitioner.

The court of appeals correctly rejected petitioner's attempted application of the "origin of the claim doctrine" to this case. As the court explained (Pet. App. 10):

> [Petitioner's] claims were not settled; she sold her claims against Ken's estate to Tenneco for a $5.75 million payment. This payment did not operate to extinguish her underlying claims against the Estate; rather, it expressly transferred her claims to Tenneco. Consequently, regardless of whether [petitioner] might have thought subjectively that this payment was in settlement of her claims—in lieu of a tax-free Estate distribution—the fact is inescapable that the $5.75 million payment is the proceeds of the sale of her unextinguished claims.

The agreement between petitioner and Tenneco did not settle petitioner's marital claims against the bank-

ruptcy estate; it merely transferred those claims to Tenneco. The payment from Tenneco did not, in form or substance, constitute a transfer from the estate to petitioner. Moreover, even if it had, petitioner is not the "debtor" to whom tax-free distributions may be made under Section 1398(f)(2). She was instead a claimant against the bankruptcy estate. The transfer of assets from a bankruptcy estate to a claimant against the estate does not qualify for tax-free treatment under the plain text of Section 1398(f)(2).

b. Petitioner errs in contending (Pet. 12-16) that the decision in this case narrows the "origin of the claim doctrine" and thereby conflicts with *Lyeth* v. *Hoey*, *supra*.[3] The *Lyeth* case involved an heir who contested a will that left him a small legacy while leaving the residue of the estate to the founder of the Christian Science religion. The heir claimed that the will was invalid due to lack of capacity and undue influence. Under the settlement of that will contest, the heir received $140,000 from the residue of the estate. The Internal Revenue Service treated the settlement payment as income to the heir in the year it was received. This Court held, however, that the property had been acquired "by bequest, devise, or inheritance" and was therefore not subject to the federal income tax. 305

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[3] Petitioner also erroneously contends (Pet. 12-14) that the decision in this case conflicts with *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580 (1970), *Woodward* v. *Commissioner*, 397 U.S. 572 (1970), and *United States* v. *Gilmore*, 372 U.S. 39 (1963). Those cases involve the deductibility of litigation costs in the context of divorce and corporate restructuring transactions and are plainly inapposite to the facts of this case.

U.S. at 195-197. The Court explained that (*id.* at 195-196):

> [Lyeth] was concededly an heir of his grandmother under the Massachusetts statute. It was by virtue of that heirship that he opposed probate of her alleged will which constituted an obstacle to the enforcement of his right. * * *
>
> * * * * *
>
> There is no question that [Lyeth] obtained that portion [of the decedent's estate], upon the value of which he is sought to be taxed, because of his standing as an heir and of his claim in that capacity.

The facts of *Lyeth* are, of course, quite different from those of the present case. Moreover, the reasoning of *Lyeth* contradicts petitioner's position in this case. In entering into the agreement with petitioner, Tenneco was not acting on behalf of her husband's bankruptcy estate and did not seek to satisfy petitioner's marital claims. Instead, as the record demonstrates (Pet. App. 2-3, 18-19), Tenneco's concern was to limit its potential liability under the gas purchase contract. Under the agreement with petitioner, Tenneco *acquired* her claims against the bankruptcy estate; it did not *extinguish* those claims. Under the reasoning of *Lyeth*, since payments made to petitioner pursuant to the gas purchase contract would unquestionably have been taxable, the amounts paid to petitioner in settlement of her claims under that contract should also have the same character and are therefore plainly subject to tax. See *Lyeth* v. *Hoey*, 305 U.S. at 195-197.

Petitioner errs in contending (Pet. 14-16) that the decision in this case conflicts with the holdings of other circuits. Those decisions, like *Lyeth*, simply hold that

the nature or character of amounts received in settlement of a claim turns on the nature of the claim settled. See, *e.g.*, *Alexander* v. *Internal Revenue Service*, 72 F.3d 938, 942-944 (1st Cir. 1995); *Parker* v. *United States*, 573 F.2d 42, 46-48 (Ct. Cl.), cert. denied, 439 U.S. 1046 (1978); *Early* v. *Commissioner*, 445 F.2d 166, 170 (5th Cir. 1971); *Turzillo* v. *Commissioner*, 346 F.2d 884, 887-888 (6th Cir. 1965); *Commissioner* v. *Murdoch*, 318 F.2d 414, 426-427 (3d Cir.), cert. denied, 375 U.S. 879 (1963); *Victor E. Gidwitz Family Trust* v. *Commissioner*, 61 T.C. 664, 673 (1974). None of those decisions holds that the purchase by an unrelated third party of a taxpayer's right to sue a debtor in a bankruptcy case is to be characterized as a payment from the bankruptcy estate to the "debtor" under Section 1398(f)(2) of the Internal Revenue Code.

3. Petitioner errs in contending (Pet. 18-21) that a failure to treat her as a "debtor" for purposes of Section 1398(f)(2) of the Internal Revenue Code would deny her equal protection of the laws. A different tax treatment of debtors and claimants against the bankruptcy estate is constitutionally permissible.

The guarantee of equal protection under the Due Process Clause of the Fifth Amendment is "essentially a direction that all persons similarly situated should be treated alike." *City of Cleburne* v. *Cleburne Living Center*, 473 U.S. 432, 439 (1985) (quoting *Plyler* v. *Doe*, 457 U.S. 202, 216 (1982)). See also *Schlesinger* v. *Ballard*, 419 U.S. 498, 500 n.3, 507 (1975). A "debtor" and a person who possesses a claim against the bankruptcy estate are plainly not "similarly situated." As a nonfiling spouse who had an interest in the community property transferred to the bankruptcy estate pursuant to 11 U.S.C. 541(a)(2), petitioner was entitled to and did file a claim against the estate. 11 U.S.C. 101(10), 501.

By contrast, her husband, who was the "debtor" in the bankruptcy case, retained no interest in the non-exempt community property transferred to the bankruptcy estate and was entitled only to any excess property that might remain after satisfaction of all claims. 5 *Collier on Bankruptcy* ¶ 541.04, at 541-12 (rev. 15th ed. 1999). Because a bankruptcy estate is a separate taxable entity that directly recognizes and pays tax upon the items of income to which the estate is entitled (see page 5, *supra*), the bankruptcy estate involved in this case was required to and did pay federal income taxes on the $7 million settlement payment that it received from Tenneco (see page 3, *supra*). After that tax was paid, if any property had remained to be distributed to the "debtor," Section 1398(f)(2) would operate to prevent a double tax being imposed on that amount received by the "debtor." By contrast, since petitioner was not the "debtor," the bankruptcy estate paid no tax on the settlement she made with Tenneco. As a claimant against the bankruptcy estate, she was thus not similarly situated with the "debtor" in the tax treatment of these transactions. The different treatment of her settlement merely reflects—and equalizes—these differences in the tax treatment of "debtors" and non-debtors.

Section 1398(f)(2) is thus designed to achieve, not undermine, equal taxation of similar items of income. By recognizing these differences in the tax treatment of debtors and non-debtors, Section 1398(f)(2) does not deny equal protection of the laws. See *Schlesinger* v. *Ballard*, 419 U.S. at 500 n.3, 507; *Richard* v. *Hinson*, 70 F.3d 415, 417 (5th Cir. 1995), cert. denied, 518 U.S. 1004 (1996). There is no conflict among the circuits nor other reason to warrant review of the decision in this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 98-1639

In The

Supreme Court of the United States

SUSAN TAYLOR MARTIN,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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PARTIES TO THE PROCEEDINGS

All parties to the proceedings in the United States Court of Appeals for the Fifth Circuit are listed in the caption: petitioner, Susan Taylor Martin, plaintiff-appellant below, and respondent the United States of America, defendant-appellee below.

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INTRODUCTION

Bankruptcy Code Section 541(a)(2) makes "all interests of the debtor and the debtor's spouse in community property *as of the commencement* of the case" property of the Bankruptcy Estate, and *at the termination* of the Bankruptcy Estate, Section 726(c)(2)(A)-(D) provides that after payment of general and administrative expenses, the community property is segregated from other bankruptcy estate property into four subestates, claims are paid in accordance with (A)-(D), *and thereafter, an equal distribution results to each spouse or former spouse of what remains of the community property.*

Respondent raises three points in its opposition, none of which has any merit.

- Respondent argues for strict construction, which it consistently argued in the courts below. Respondent argues that because Susan is not a "debtor" she is not entitled to the § 1398(f) exclusion. Other sub-arguments from strict construction are that Susan did not receive her money from the bankruptcy estate, nor did she receive it at the termination of the estate. Respondent further suggests (Opp. p. 6, fn. 2) that the Fifth Circuit's decision involves a factually unique situation which does not affect others.

  Susan argues that the strict constructionist approach must be rejected because it results in arbitrary and patently unequal treatment of co-owners of community property. Susan refutes the suggestion that there are no other persons affected by the Fifth Circuit's decision. There are numerous, perhaps thousands of non-filing spouses who stand to receive distributions from their filing spouse's bankruptcy trustee and who will now be required to pay taxes on those distributions.
- Respondent argues that the "origin of the claim doctrine" should not be applied to the

Tenneco payment received by Susan. Every single reported case which has defined and then applied the "origin of the claim doctrine" mandates that the Tenneco payment to Susan be afforded the benefit of the IRC Section 1398(f)(2) tax exclusion. The doctrine is a *general one* and is not limited to the particular fact situations of previously reported cases. It is a singular doctrine which applies uniformly to both expenses/deductions taken, and to monies received.

- Susan refutes Respondent's position that she is not similarly situated because she is a "claimant" and not a "debtor". These differences are irrelevant and immaterial. Respondent is looking in the wrong place to find alleged dissimilarities. When considering the financially wounded non-filing spouse in community has involuntarily lost her community property interests under 11 U.S.C. § 541(a)(2), the pertinent and relevant *situation, context, and circumstance,* is not their respective status as "debtor" and "claimant" *within the bankruptcy proceeding*. **The relevant situation, circumstance and context, is their property ownership status as equal co-owners of the community property at the moment immediately preceding the commencement of the bankruptcy estate, as well as their co-equal entitlement to receive an equal distribution of what remains of the community property at the end of the bankruptcy estate under 11 U.S.C. § 726.**

The petition for writ of certiorari should be granted.

ARGUMENT

1. Respondent's strict construction ignores the substance of the transaction, inflicts a palpably arbitrary and patently unequal treatment upon one of two equal and identically situated co-owners of community property, and affects a significant number of community property owning spouses.

Conspicuous by its absence in Opposition Argument Number 1 is any reference to ***subsection (a)(2) of Bankruptcy Code Section 541 which operates to make the community property interests of the non-filing spouse property of the bankruptcy estate.*** This case deals exclusively with the community property of the non-filing spouse and the only focus should be on subsection (a)(2) of Bankruptcy Code Section 541. Any overlap between subsections (a)(1) and (a)(2) with regard to the debtor[1], is irrelevant because both operate in exactly the same manner, that is, both accomplish an absolute and total divestiture of all community property ownership interests of the debtor and the debtor's non-filing spouse, and vest those interests in the bankruptcy estate. There is no retention of any ownership interests by either the debtor or the debtor's non-filing spouse after all community property ownership interests vest in the bankruptcy estate.

The Fifth Circuit's decision damages all non-filing spouses in community property states. It is not as narrow a holding as Respondent argues. The Fifth Circuit's opinion is a case of first impression; the decision now provides case law precedent justifying IRS attempts to tax distributions received by the non-filing spouse under 11 U.S.C. § 726. The Fifth Circuit's opinion *clearly holds without qualification* that the non-filing spouse is not a "debtor". It is *not*

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[1] 11 U.S.C. § 541(a)(1) would apply to all the debtor's separate property and the debtor's half of the community property, whereas subsection (a)(2) is more specific and applies to community property.

limited to the situation where a non-filing spouse sells his/her claim to a third party prior to a distribution. Presently there are numerous non-filing spouses who are waiting to receive distributions from their filing spouse's bankruptcy estates. In 1998 1.4 million Americans filed for personal bankruptcy, a nearly 95% jump since 1990.[2] Prior to the Fifth Circuit's decision, no reported case permitted attempts to collect taxes from a non-filing spouse on his/her 11 U.S.C. § 726 distribution. In the past such distributions probably went unreported and untaxed because the recipients and possibly the IRS viewed them as simply returns of what remained of one's own property and assumed that no taxes could possibly be owed. Unless this Honorable Court reverses the Fifth Circuit's decision, such reasonable assumptions are no longer true. Also, some peculiar, burdensome, and odd consequences follow: as the non-filing spouse is not considered a "debtor", then a burden to report a taxable transaction is imposed upon the non-filing spouse in the commencement year of the bankruptcy, arising from the involuntary exchange of the non-filing spouse's former interest in the community property for a claim against the filing spouse's bankruptcy estate. Whether or not any gain or loss is recognized has nothing to do with whether the transaction is classified as "taxable" or "nonrecognition".[3] Although the trustee is not before the court, the Fifth Circuit's decision also causes her

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[2] *The Wall Street Journal*, May 6, 1999, "House approves bankruptcy overhaul amid criticism bill may be too tough." Section A, Page 28, 5th Paragraph. Schlessinger, Jacob M.

[3] 26 U.S.C. § 7701(45) defines a *nonrecognition transaction* as "any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A." **The receipt by the non-filing spouse of a claim to an eventual § 726 distribution is not anywhere defined by the IRS code as a nonrecognition transaction. Accordingly the transaction would have to be reported and any gain or loss thereon calculated, however difficult that task might prove to be.**

problems. The vesting in the bankruptcy estate of the non-filing spouse's half interest in the community property would have to be reported and gain or loss calculated (supra, at fn. 3), because the non-filing spouse is not a "debtor", and only transfers (no distinction is made between voluntary and involuntary) between the bankruptcy estate and the "debtor" are exempted from tax under IRC 1398(f).

2. The "origin of the claim doctrine" requires that the Tenneco payment to Susan be afforded the benefit of the IRC Section 1398(f)(2) tax exclusion.

Respondent argues that the "origin of claim doctrine" should only apply to monies received in settlement of a claim and not to sale proceeds received from a third party purchaser of the claim. This argument is not well founded and has no rational basis. Although most past cases involving the receipt of money did involve settlement of claims, the doctrine is not, nor should it be, restricted only to monies received in settlement of claims. Furthermore, the "settlement versus sale" distinction is unimportant. Every case involving the "origin of claim doctrine" decided by this Honorable Court and lower Federal Courts has followed a *general approach* in applying the doctrine. A purported distinction between a transaction that keeps the claim alive, and a payment which extinguishes or settles the claim is simply a *formalistic distinction* that has no merit in determining the tax consequences. (Pet. p. 15). Furthermore, past fact situations where the doctrine was applied do not limit its application to different facts which squarely fall within its concept and philosophy; ***it is the fundamental and underlying reality and substance of any transaction which determines the tax consequences***. The "origin of claim doctrine" has nothing to do with *who* paid the money, *why* a purchaser bought the claims, or *what* they subsequently did with the claims. This Honorable Court is asked to apply the doctrine to the monies Susan received. This case *does not* involve the tax classification of

the monies which Tenneco spent. Tenneco is not before this Court.

Respondent argues for a distinction between those cases where the "origin of the claim doctrine" was applied to expenses and deductions and those cases involving the receipt of monies. There should be no distinction whatsoever. The doctrine is singular and is to be uniformly applied to both situations. Respondent argues that *Lyeth v. Hoey*, 305 U.S. 188, 59 S. Ct. 155 (1938) is factually distinct from the instant case. The facts in *Lyeth v. Hoey*, supra, are certainly different, but conceptually the "origin of the claim doctrine" as enunciated in that case by this Honorable Court is identical. **Whatever may be the facts, the doctrine requires that the fundamental question, "for what was the money paid?" must always be answered. In Susan's case, the only thing that Susan could sell, and the only thing which could be purchased, was her claim against her husband's bankruptcy estate for a distribution under 11 U.S.C. § 726.**

Respondent admits that the bankruptcy trustee is *a separate legal and taxable entity* and is responsible for payment of all taxes relating to bankruptcy estate property. Respondent emphasized that the property of the bankruptcy estate includes all of the spouses' former community property. Curiously, Respondent (Opp. p. 9) retreats from its admissions by now claiming that the money Susan received from Tenneco should be treated, under the "origin of the claim doctrine", as if those monies had been received by her as an owner of the Gas Purchase Contract. Respondent avoids discussing the effect this argument would have on Ken and the trustee. One could argue Ken has to pay taxes on the proceeds the trustee received and further that the trustee is excused from paying taxes. Worse yet, both may be said to owe taxes. Obviously, Respondent's argument is meritless because *the "origin of the claim doctrine" cannot be applied beyond the point in time that Susan lost under Bankruptcy Code § 541(a)(2) her former equal ownership interest in the community property*. The claim for a Section 726 distribution received by operation of

Section 541(a)(2) is not an ownership interest in the Gas Purchase Contract nor an ownership interest in any other bankruptcy estate asset. *Susan and the trustee cannot own the entire interest in the same thing at the same moment in time.*

3. A failure to treat Susan as a debtor for purposes of conferring the benefit of the tax exclusion under IRC Section 1398(f)(2) denies her equal protection of the laws as guaranteed by the Fifth and Fourteenth Amendments of the United States Constitution. When considering the situation, circumstance and factual context of the non-filing spouse in community, the claimed distinctions of "debtor" and "creditor" are not relevant and are not material.

When a denial of equal protection question arises, the **first step** is to identify and define the circumstance, context or situation within which the denial occurs. In some circumstances and situations a group of individuals may share little or no similarities, whereas in other contexts, circumstances and situations, members of the group may share identical characteristics. Put another way, *the relevant situation, context and circumstance* (hereinafter, "right place") must be initially determined.

The **second step** is to examine the claims of similarities and/or differences to determine if they exist within the right place. Any so-called differences described by Respondent must be examined to see if they fall outside of the right place. If the cited differences are indeed *outside of any relevant situation, context, and circumstance* (hereinafter, "wrong place"), those differences are immaterial and irrelevant.

The differences cited by Respondent are the result of looking in the wrong place. When considering the denial of equal protection to the non-filing spouse who has lost involuntarily and by operation of law his/her entire interest in the community property, the wrong place to look is *within the bankruptcy proceeding. It is only the bankruptcy proceeding that reclassifies the two community property owners as "debtor" and "claimant".*

The right place to look is the spouses' property ownership status as equal co-owners of the community property at the moment *immediately preceding* the commencement of the bankruptcy estate, and the right of each to receive an equal distribution of what remains of the community property *at the end* of the bankruptcy estate. 11 U.S.C. § 726. As stated in petitioner's application, there are nine community property states, and Louisiana is one of them (Pet. p. 3). Louisiana Civil Code Article 2336 establishes the fundamental rule of Louisiana Community Property:

> "Each spouse owns a present undivided one-half interest in the community property. . . . "

Immediately preceding the commencement of the bankruptcy estate Susan and Ken owned a *"present undivided one-half interest in the community property"*. After the moment of filing but prior to the time of a final distribution, all of the former community property belonged to the bankruptcy estate. (11 U.S.C. § 541(a)(2)). There is absolutely no difference between the spouses in community immediately prior to the filing of the bankruptcy, and there is no difference between them with respect to the manner that Section 541(a)(2) deprives each of them of their half interests in the community property. Ken and Susan are identically situated.

Each perceived difference between the spouses described by Respondent is the result of looking in the wrong place. *What happens to both within the bankruptcy is not the relevant factual situation, context, or circumstance.*[4] If Respondent would search in the right place, it would be at a loss to find any differences at all.

An equal protection analysis under the due process clause of the Fifth Amendment requires a showing that the class discriminated against suffers from a significant deprivation of a benefit or the imposition of a substantial

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[4] Irrelevancies include: ability to file a proof of claim, a preferential purchase right, and the status of "debtor" versus "claimant".

burden. *Califano v. Boles*, 443 U.S. 282, 295, 99 S. Ct. 2767, 2775 (1979). The equal protection clause of the Fourteenth Amendment is an additive to the protection guaranteed by the Fifth Amendment. *Hampton v. Mow Sun Wong*, 426 U.S. 88, 100, 96 S. Ct. 1895, 1904 (1976). Susan is a member of that class of persons most appropriately defined as **non-filing spouses who lose their undivided half interest in community property to the bankruptcy estate of their filing spouse by operation of 11 U.S.C. § 541(a)(2).** This class suffers a significant deprivation of a benefit, that is the tax exclusion afforded to the filing spouse by 26 U.S.C. § 1398 (f)(2). This class is identically situated in all respects to the debtor (filing spouse) as to their ownership interest in the community property and with respect to their right to receive an equal distribution of what remains of their community property at the end of the bankruptcy estate. There is no reason why one spouse should be afforded the benefit of a tax exclusion and the other denied that benefit. Respondent has not asserted that this denial of equal protection is somehow justified by some compelling or overriding national interests. It is apparent that there could not possibly be any rational justification for treating community property owning spouses differently by exempting one from tax and not the other upon the return of what remains of their own property.

CONCLUSION

There is a grim irony present in this case. Ken initiated a proceeding under Chapter 7 and listed almost nothing on his bankruptcy schedules, concealing an asset worth many millions of dollars. Susan refused his requests to join in the filing of his fraudulent Petition. Susan provided key and pivotal evidence which resulted in the trustee successfully obtaining a judgment in the bankruptcy court holding the Gas Purchase Contract to be community property and property of the bankruptcy estate. (Pet. p. 4). The trustee later settled Tenneco's liability for millions. When Ken received his distribution, he was afforded the benefit

of the Section 1398(f)(2) tax exclusion, however, after Susan sold her claim for the identical distribution, she was required by Respondent to pay a tax on the sale proceeds. She is being deprived of a substantial benefit because she decided to extricate herself from the bankruptcy morass into which she was involuntarily tossed by the filing of a fraudulent petition by her estranged husband.[5]

The Fifth Circuit's decision has a much broader application than Respondent would like this Court to believe. It is the first decision of its kind which holds that the non-filing spouse in community, regardless of whether she sells her claim or retains it, is *not a debtor* and therefore is not entitled to the benefit of the tax exclusion under 26 U.S.C. § 1398(f)(2).

Susan's petition for a writ of certiorari should be granted.

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Respectfully submitted,

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[5] Memorandum Opinion of Hon. T.M. Brahney, III, dated August 19, 1993 in *Marrero versus Bordelon, et als.*, Adversary 92-1036 (Bankr. E.D. La. 1993) at 18 and 22-23.